Cost Shielding in Executive Bonus Plans
(Bloomfield et al. 2019)

Discussion by Zacharias Sautner
My Impression

• Important paper with useful stylized facts
  • I learned something!

• What would I do next?
  • Explore additional test using FAS 123-R
  • Address some alternative hypotheses
  • Try to tackle the “so what? question”
1. Additional test

• Ideal experiment
  • Change a cost item without changing firm fundamentals
  • See how board responded to change in cost item in terms of cost shielding

• FAS 123-R in 2005
  • Option compensation costs moved from footnotes to income statement
  • No change in fundamentals; staggered compliance (Ladika/Sautner 2019)
  • Board should adjust bonus pay to shield against it

• Do we see a response?
  • If board shield CEOs from costs, we should see a change in bonus contracts from before to after
2. Alternative explanations

• Industry factors?
  • Cost shielding may be driven by characteristics of a firm’s industry
  • Explore explanatory power of industry fixed effects?
  • Analysis currently only uses year fixed effects

• Managerial opportunism?
  • Substantial year on year variation in cost shielding
  • CEOs may exercise power to remove less beneficial cost items
  • Estimate Removal = f(Change in Cost Items; ...)
  • Explore how sensitivity of cost shielding varies with managerial power
    • CEO Pay slice; E index; etc.
3. So what?

• “Bonus plans mitigate agency conflicts“
  • What agency problems do you have in mind and how do your hypotheses relate to them / how does cost shielding reduce them?

• Taking results at face value, want to see that shareholder value is affected if cost shielding creates value

• Currently no links to performance or returns

• Can you see any financial disadvantages from suboptimal cost shielding?
  • Create measure of deviation from optimum (industry average) and relate to performance or valuation measure
4. Smaller Questions

• What is the role of compensation consultants?
  • Do board really design structure of bonus pay?
  • Evidence that pay consultants play an important role
    • Murphy and Sandino (2010)

• How important is bonus pay overall?
  • Is it a first order component of total pay? Should be care?
  • Add summary stats relative to equity pay
4. Smaller Questions (continued)

• How do you account for other performance criteria in bonus plans
  • About 40% of performance measures are not IS measures
  • Measures are likely interrelated, affect incentives
  • For example, relative performance also allows for cost shielding if systematic across industry

• Key result: “More cost shielding when costs are noisier”
  • Makes sense from contract theory perspective (risk averse CEOs)
  • Empirical measure is volatility in cost items over past ten years
  • Wouldn’t informativeness principle (Holmström) suggest use of an idiosyncratic measure? Firm-specific volatility?
Thank you and good luck with the paper!