Melissa Martin and Teemu Malmi in dialogue with Utz Schäffer

„Compensation contracts have become too complex“

Getting compensation contracts right is one of the trickiest issues in management. In this interview with Utz Schäffer, Melissa Martin of University of Illinois – Chicago and Teemu Malmi of Aalto University in Finland discuss current challenges and what makes compensation contracts effective.

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is the Michael B. Mikhail Associate Professor of Accounting at the University of Illinois – Chicago. Melissa's research interests focus on executive compensation and management control systems using both field and archival data. Melissa Martin serves as an associate editor for the European Accounting Review and editor for The Journal of Management Control and as an editorial board member of The Accounting Review, The Journal of Management Accounting Research, Management Accounting Research, and Accounting Horizons. She has published her work in Contemporary Accounting Research, Accounting, Organizations, & Society, Review of Accounting Studies, Management Science, Academy of Management Journal, Journal of Applied Psychology, Journal of Management Accounting Research, Management Accounting Research, among others. She received her PhD from the University of Southern California, her undergraduate and master's degrees from Texas A&M University.

Managerial compensation has been a hot topic being discussed for many years, now. Melissa and Teemu: What are your general opinions with respect to managerial compensation?

Teemu Malmi: Managerial compensation can be used for different purposes such as attention direction, motivation, attracting and retaining talent and one should always think first what one wants to achieve by managerial compensation. There is no silver bullet or one size fit for all solution to compensation – it needs to be tailored to fit the circumstances. As there are very many factors that either make compensation effective or not, this makes designing and using managerial compensation challenging, but also interesting.

Melissa Martin: I think that managerial compensation contracts have become too complex in recent years. Calculating a bonus payout is incredibly difficult notwithstanding the complexity introduced by additional contract features such as other elements of pay, target types, and multiple payout periods. Given the complexity of existing contracts, I find it difficult to believe that the manager can distill the preferences of the board from these contracts in order to decide where to direct their effort and even more that the board can trace their preferences to the contract.

So companies would benefit from simpler schemes?

Melissa Martin: Yes! There are several new papers studying the influence of CEO compensation contract complexity on firm performance and they document a negative effect of complexity on firm performance. However, proxy advisor firms are often looking for very specific performance contingent compensation features and similarity among peers. That being said, 2022 had the highest Say-On-Pay failure rate in US history. In 2023,

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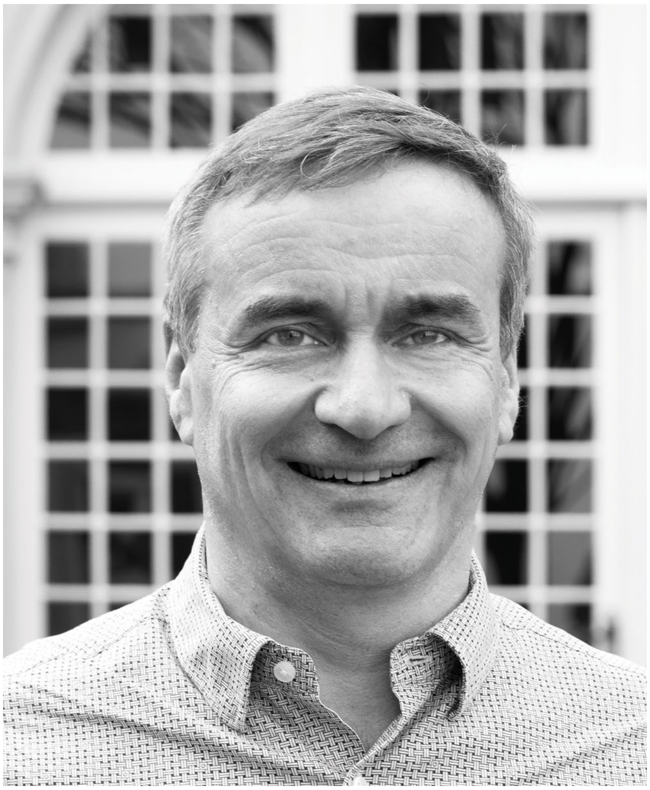
the Institutional Shareholder Services group of companies (ISS) updated their compensation guidelines to firms indicating that contract complexity that hinders the ability to assess the linkage between pay and performance will result in unfavorable SOP recommendations. They refer to "a disproportionately large number of metrics, modifiers, and/or award vehicles, complicated vesting or award determination formulas, or convoluted disclosure without clear and compelling rationale" as examples of



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Teemu Malmi
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overly complex pay programs. However, these same guidelines point to the need for clear connection to multiple dimensions of performance and similarity in pay practices to relevant peers, making the assessment of complexity quite complex itself!

Teemu Malmi: As an economist, I would argue that if we observe these systems to be complex in practice, there must be good reasons for it. However, to keep it simple is a good advice to start with, perhaps slightly rephrased as "keep it as simple as possible". Unfortunately, it is not easy to keep these schemes simple, as short-term financial incentives are known to cause myopia, and hence many schemes contain these long-term components for good reason. Similarly, as many organizations have both financial and ESG related objectives these days, it seems natural that also the achievement of ESG related objectives determines pay. One way to keep things simple is to rely on share-based schemes with lock-up periods. This is of course dependent on the availability of using shares as a form of compensation.

Melissa, which specific research questions keep you awake at night?

Melissa Martin: There is so much we still need to learn: Why and how are hurdles, multipliers, and adjustors used in annual bonus contracts? Why and how are performance vesting shares used, particularly given the existence of time-vesting shares and both annual and long-term incentive pay? Why are relative performance evaluation contracts often paid out in equity shares? These contracts are used to remove common noise from contracting performance metrics but then rewarded with equity that is subject to both systematic and idiosyncratic performance. Last but not least, I am also interested in examining how the availability of frequent internal performance reports and analytics tools might alter the ability to implement a complex contract.

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Teemu, what about you?

Teemu Malmi: I think we should always ask how we get the best out of managers or employees, whether the best means profit, cash flow, innovation, productivity, environmental performance, or something else. And as leaders have a multitude of mechanisms and practices available to them, we need to ask how managerial compensation should be used in conjunction with other managerial practices. One interesting angle to this relates to multinational organizations. Should we use similar managerial compensation practices in units operating in different cultures or should those systems be tailored to local cultures to be effective? One of our recent studies looked at what management practices complemented delegation of authority in different cultural contexts. We found that incentive systems complement delegation in Anglo-Saxon cultures, as classic agency theory would predict, but in Germanic and Nordic cultures delegation was complemented by participation in strategic and operational planning.

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It also seems that executive bonuses tend to be higher in the United States. Do you agree with this observation?

Melissa Martin: Bonuses do tend to be of a larger absolute value in US firms, but relative to the total compensation payout they are similar in size. There are potentially some regulatory differences impacting this including the 162M regulation that only allows the deductibility of compensation expense to the extent that it is performance-based.

Teemu Malmi: I agree. Overall, variable compensation plays a bigger role in the United States and part of that could be related to national culture. But also perhaps due to the fact that job markets for leaders are still relatively local and the US job market is far bigger than in any single European country. Other reasons may be a slightly bigger average organization size, the development of stock markets and taxation. In the US there is a limit to the extent companies can deduct cash compensation in their taxation. This leads to a higher emphasis on stock-based schemes.

Let us move further down the hierarchy: Here, popular concepts such as Agile and Beyond Budgeting suggest that bonuses should be awarded not for individual, but for team or company performance or – ideally – not at all. What are your thoughts on this?

Melissa Martin: Short-term bonuses serve a very important role in that they reward current effort toward a desired task. Often there is uncertainty in the outcome to a current investment of manager effort – using only equity-based compensation then cannot reward this effort, particularly when the payoff to the effort is risky. It may be a long time before the market gets or incorporates this information about an executive action. When it does, the market reaction reflects the cash flow impact and not the desirability of the manager's effort.

Teemu Malmi: In case you get the most out of your people without providing financial bonuses, and they are willing to join and stay, why should you award bonuses? The question between individual vsersus team or company gets back to organizational interdependences. A division manager who runs a business that has very little interdependency with other divisions should probably be rewarded by individual merits. A division manager whose performance is dependent on or affects the performance of other divisions should probably not be remunerated based on their division performance only. I guess the idea of these popular management concepts is that team-based models foster collaboration, information sharing and learning.

Which is why companies that use the concept of Objectives and Key Results should not pay their managers bonuses for the achievement of specific objectives or key results …

Teemu Malmi: Yes. In case bonuses are paid for achieving agreed upon targets, managers are not willing to set aspirational targets. In fact, the incentive is opposite, setting targets as low as possible will maximize the bonus. In the OKR method, targets are typically set for three months, but remuneration is decoupled from the achievement of these targets. This does not mean that companies that use OKR's do not pay bonuses, but they try to drive performance by aggressive targets set by managers themselves, and all understand that if the firm performs well, there will be money for bonuses that are based on the company's or business unit's performance.

In their bestselling book "No rules rules" Reed Hastings and Erin Meyer report that Netflix awards no bonuses for managerial performance but rather works with top-of-market salaries and market mechanisms for salary adjustment. Could that also work for other companies?

Teemu Malmi: Research tends to argue that intrinsic motivation is a much stronger driver of performance than extrinsic. Some people join firms or other organizations to contribute to something important, to do something they like, to learn new things and some just for getting their living. I think that no financial bonuses could work for organizations that either serve

for some higher purpose or provide other elements that attract and motivate talented people. It is also argued that in highly demanding, complex jobs the main thing is to pay enough to get the issue of money off the table.

Melissa Martin: While a firm may heavily rely on alternative control mechanisms to ensure alignment between shareholders and managers, these control mechanisms are less observable by outsiders and it is difficult to assess their effectiveness at controlling manager behavior. This is a big reason shareholders prefer incentive-based compensation – the link between pay and performance is observable and can be used to assess the quality of monitoring. Because shareholders are actively monitoring how the board monitors the CEO, firms are constrained in their choices. This is especially salient in the post-SOP era. Even Netflix has had their compensation plan voted down 3:1 in their 2023 SOP vote, resulting in a commitment by the firm to radically alter their executive pay practices to move to a more traditional compensation structure. Given the strong regulatory focus, and in particular the focus on the link between pay and performance and the similarity to peer firms I find it difficult to believe that such a structure could be used at the executive level in a publicly traded US firm.

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We all agree that culture matters. What about other factors such as the environment – consultants would readily talk about a VUCA or not so VUCA world – and personality characteristics – the Beyond Budgeting people distinguish between McGregor's Type Y and Type X?

University of Illinois

The University of Illinois – Chicago is the only public research university located in Chicago. The university enrolls more than 34.000 students and is commended for its mission and innovation. UIC has achieved several accolades including the US News and World Report ranking of 8th for social mobility and a top 50 most innovative university. The College of Business ranks high in all disciplines in terms of research productivity, ranks 12th worldwide in managerial accounting research and 3rd in archival management accounting research in the prior six years (BYU Ranking).

Melissa Martin: It seems likely that individual characteristics and preferences should matter in compensation contracting. They may be easier to act on at lower levels in the hierarchy. At the top executive level, we need to assume that the issue is largely addressed by self-selection. That is, compensation contract terms lead individuals to select into or out of firms offering different compensation types. At the same time, there are obvious limits to self-selection such as the scarcity of open positions and the transparency of and consequences to these executive moves.

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Teemu Malmi: The traditional economic argument states that the more VUCA the world around our business is, the more risk they face and the more managers should be compensated for accepting that risk. Of course, compensation may come in the form of both, higher than average base salaries or, alternatively, bonuses. Think about leaders of tech start-ups: Managers accept a low base salary, but the upside equity schemes promise makes the deal attractive. In a VUCA world, it is not obvious what leaders should do to be successful. Therefore, it is not easy to link compensation to traditional KPIs. However, share-based schemes should work. At the same time, we can observe that younger generations – at least in the Nordic countries – value spare time more than previous generations and many of them are not willing to trade off time for money. This has become evident in consulting firms or law firms. And these young people are not willing to put in similar hours their current bosses did when climbing up the pyramid. So, I guess the basic rule of designing reward systems still holds: Understand what kind of rewards your subordinates value.

Do you also agree or not agree when these management concepts suggest that – in a sufficiently dynamic environ-

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ment performance and bonuses should not be linked with an ex ante defined formula but that they should be awarded at hindsight, based on a subjective evaluation of performance and behavior?

Melissa Martin: There are of course benefits to the ability to adjust payouts for events, particularly those outside of the manager's control, and to remove some of the compensation risk to the manager. There is also a benefit to including a subjective component to bonus payouts in the sense that proprietary contracting metrics are not communicated to peers and competitors. However, objective performance metrics serve another role in that pre-determined metrics serve a signaling role to communicate to the executive where their effort is most valuable. Not to mention that using subjectivity makes it difficult for shareholders to assess the relation between pay and performance leading to increased scrutiny by regulating bodies.

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Teemu Malmi: The problem with dynamic environment comes from factors that are not under the control of managers. Those may provide huge windfall gains or drive businesses in the red no matter what managers do. This does not mean, however, that ex ante defined formulas cannot be used. Performance can be measured relative to peers, such as for example the Handelsbanken case suggests, and a certain proportion of profits paid out as bonuses when performance is better than that of peers. But there are also good arguments for using subjective evaluation in dynamic environments.

Last but not least: what is on your wish list as researchers? What can we and our community do, what can companies do to make our research even better and even more relevant?

Melissa Martin: We cannot understand the true incentive properties of contracts when our analysis relies on breaking them down into a series of indicator variables that represent different contracting strategies. We have to examine the totality of the contract. However, most contracts are incredibly complex and idiosyncratic making it costly for researchers, particularly those using a large sample archival strategy, to study the average effects of these contracts. We have to be willing to employ creative empirical methodologies and small sample qualitative and quantitative studies to better understand why and how firms implement these contracts and their performance effects. We also need companies to help us better understand the rationale in their contracting choices, the role of compensation consultants, and the eye toward regulatory compliance versus optimal firm fit.

Teemu Malmi: Much of the compensation related research has focused on top-management because information is publicly available. We would need a better understanding of the role of compensation as part of the managerial toolbox within organizations – what mechanisms work well for middle managers and employees and in which circumstances. We still have relatively little research on how compensation is determined and how those who are compensated take part in the process. What is the role of consultants, the skills and competence of compensation committee, etc. And as mentioned earlier, we should also create a better understanding of compensation practices in different countries as there are large differences in cultural and institutional circumstances.

Absolutely. There is no silver bullet with respect to executive compensation and many questions remain open. I hope that this interview, our research and the ongoing dialogue between practice and academia will help executives to find a compensation contract that suits them well. Melissa, Teemu, thank you for your time!

The interview was conducted by Prof. Dr. Utz Schäffer, Director of the Institute of Management Accounting & Control (IMC) at WHU – Otto Beisheim School of Management, Vallendar, and publisher of the Controlling and Management Review.
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