

CODE SECTION 162(M), PAY SENSITIVITY ESTIMATES AND THE VALUE OF SUBJECTIVITY IN COMPENSATION ARRANGEMENTS

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ABSTRACT

We examine the impact that Internal Revenue Code Section 162(m) had on the pay for performance relations for two sets of firms- those that qualified their CEO's annual bonus under IRS (Internal Revenue Service) Code Section 162(m) as "performance based" and those that did not take such steps. We hypothesize that the link between the CEO's annual bonus and certain established objective measures of performance would improve the most for those firms that were "subjective evaluators" of CEO annual performance prior to complying with the conditions of Section 162(m). Our regression results are generally consistent with our hypothesis that states that the observed pay for performance improvements associated with compliance with Code Section 162(m)'s were largely driven by firms that qualified their pay programs as performance based under this law and which were using subjective performance measures to evaluate their CEO's annual performance prior to meeting the conditions of Section 162(m).

We also look at the benefits (in terms of tax savings) or the loss (in terms of added tax costs) incurred by companies which qualified (and those that did not qualify) their CEO's annual bonus as performance based under Section 162(m). We find that the tax benefits from qualifying the CEO's annual bonus as performance based were the highest for those companies which had been using subjective criteria to evaluate their CEO's annual performance prior to becoming Section 162(m) compliant. To us, this suggests that the ability to evaluate a CEO's annual performance using subjective performance measures has value to a company and that forfeiting the right to use such measures requires added tax savings to induce this behavior.

Keywords: CEO compensation; Regulation; Contracts; Corporate Governance; Subjective vs. Objective Performance Measures, Performance Measurement

