Abstract

We examine the association between executive compensation and dividend payouts of US firms. We start by hypothesizing a negative association between dividend payout and managerial quality on the grounds that higher quality managers have access to more profitable investment opportunities, and therefore have less cash available for dividend distribution. Assuming a competitive managerial labour market, we expect managerial quality and managerial compensation to be positively associated. Based on these two premises, we expect a negative association between dividend payout and managerial compensation, and indeed find it to be valid in our sample. We find that salary, bonus and stock option components are all negatively associated with firms’ dividend payouts. Finally, we find salary and option compensation and bonus and option compensation to be positively associated, and therefore salary and bonus are complements to and not substitutes for, option compensation.
Dividend Payout and Executive Compensation in US Firms

Abstract

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We find that salary, bonus and stock option components are all negatively associated with firms’ dividend payouts. Finally, we find salary and option compensation and bonus and option compensation to be positively associated, and therefore salary and bonus are complements to and not substitutes for, option compensation.
Introduction

This study examines the association between executive compensation and dividend payouts of US firms. The central hypothesis investigated in this study is developed in Bhattacharyya (2000). Bhattacharyya explains firms’ dividend policies based on the asymmetric information paradigm. Unlike the signalling models (e.g., Bhattacharyya, 1979; Williams, 1988; John & Williams, 1985; Heinkel, 1978) where the informed manager uses the dividend as a signalling device, Bhattacharyya (2000) posits dividend policy as a component of a screening contract set up by an uninformed principal. In this context, higher quality managers have access to more profitable investment opportunities, leaving them with less cash or earnings to distribute as dividends. In equilibrium, firms’ dividend payout ratios are negatively associated with managerial quality (or productivity). That is, for a given level of available cash, managers with lower productivity declare higher dividend payouts compared to managers with higher productivity.

Competitive labour markets suggest that managers of high quality will earn higher total compensation (Jensen, 1986). In light of Bhattacharyya’s model, we therefore expect to see a negative association between dividend payout and managerial compensation. This is a convenient hypothesis to test, since managerial quality and investment opportunities are not readily and objectively observable (although the market to book ratio is often used to proxy for the latter). Consistent with our hypothesis, we find a negative association between dividend payout and executive compensation. We also find that option compensation, salary and bonus are all negatively associated with dividend payouts.

Salary and bonus components of compensation packages are also positively associated with the stock option component of the compensation package, which we find puzzling. In order to understand the nature of the puzzle, first consider the case where the agent productivity type is
known. Agency theory suggests that when agent-type is known, agents are paid their reservation wage in expectation. This suggests that cash components like salary and bonus would be substitutes for option components (the ex-ante Black Scholes value) of compensation packages, and not complements. If the agent-type is not known, agents are paid information rents. In this case we need to consider whether the rent is paid in cash or with options. Since agents are risk averse, they demand a premium for accepting contingent compensation. This suggests that firms will choose to pay their managerial rents in the form of cash rather than in stock options in order to avoid paying additional risk premiums. In this case, we should expect no relationship between cash components like salary and bonus and stock option components of compensation. A positive association between cash components like salary and bonus and option compensation suggests that part of the rent may be paid in the form of stock options, perhaps because options offer accounting, tax and cash flow advantages to firms.

Formulation of Hypothesis

The theoretical framework for understanding executive compensation is the principal-agent paradigm (Jensen & Meckling, 1976) and the contracting literature (Arya, 2000; Mirrlees, 1976; Ross, 1973; Holmstrom, 1979; Fama, 1980; Lazear & Rosen, 1981). Bhattacharyya (2000) develops a model linking firms’ dividend payouts to the principal-agent paradigm. In his model, uninformed principals (shareholders) set up a menu of contracts to screen agents according to productivity type, with higher quality agents being paid higher wages (in the form of information rents), consistent with competitive labour markets. The wage functions in these contracts also have dividends as one of the arguments. Higher quality managers have access to many more positive net present value (NPV) projects, and therefore pay out lower dividends. The principal induces these dividend
choices by designing the appropriate compensation contract, and in equilibrium, dividend payout and managerial quality (or productivity) are negatively associated. We can also expect high quality managers to receive higher compensation. This suggests that dividend payout and total compensation would be negatively associated.¹

Lambert et al (1989) examined the impact of introduction of executive stock options on firms’ dividend policies. They found that introduction of executive stock options led to lower dividends relative to expectations generated by the Marsh-Merton model. Ferreira-White (1996) examined the influence of compensation plans on dividend payouts and yields, and found that both are influenced by the presence of stock options in compensation contracts. Fenn and Liang (2001) also found a negative association between executive stock options and dividends. This study examines dividend payouts as opposed to dividend levels, reflecting the need to control for the level of earnings out of which dividends are paid.

Our hypothesis (in alternate form) is as follows:

H₁: Dividend payout is negatively associated with the ex-ante value of total executive compensation.

Sample Selection and Descriptive Statistics

We get our data of executive compensation from the Execucomp database 1998, and we get our firm-specific accounting variables from Compustat. Our sample begins with a total of 4373 firm-year observations with available data in both databases. Observations are deleted due to missing data for dividend payout (10 firm-years), zero dividend payouts (2324 firm-years), negative dividend payouts (120 firm-years), dividend payouts exceeding one (118 firm-years), missing data for debt-equity ratio (5 firm-years), negative debt-equity ratio (1 firm-year) and missing data for total
compensation (173 firm-years). Model I (described below) is tested on the remaining 1622 firm-years. Restricting our analysis to firm-years with dividend payouts strictly between zero and one is necessary, since Bhattacharyya’s (2000) model on which our central hypothesis is based, applies only to firms that pay dividends out of available earnings. Firm size and leverage are included as control variables in our regression models.

Table 1 presents summary statistics for our sample. The mean (median) firm in our sample has total assets of $0.44 billion ($0.39 billion). The mean (median) total compensation is $1.1 million ($0.8 million) while mean (median) Black-Scholes value of option grants to CEOs in our sample is $0.3 million ($0.07 million) based on the Black-Scholes valuation. The mean (median) salary is $0.37 million ($0.35 million). The mean (median) bonus received by the CEOs is $0.26 million ($0.19 million). The mean (median) dividend payout ratio for firms that pay dividends out of available earnings is 0.3 (0.25).

The correlation matrix is presented in Panel A of Table 2 and the Spearman’s rank correlation matrix is presented in Panel B. Both these tables confirm that dividend payout ratios and total compensation are negatively correlated. We can also see the negative correlation between dividend payout and option compensation, between dividend payout and salary and between dividend payout and bonus compensation. Firm size is positively correlated with total compensation, reflecting that managers of larger firms are paid more.
Analysis and Results

We estimate the following OLS regression models for which results are shown in Table 3.

\[
PAYOUT_{jt} = \alpha_0 + \alpha_1 \text{TOTCOMP}_{jt} + \alpha_2 \text{LTOTASST}_{jt} + \alpha_3 \text{DEBTEQUT}_{jt} + \epsilon_{jt} \quad \text{(Model I)}
\]

\[
PAYOUT_{jt} = \beta_0 + \beta_1 \text{OPTCOMP}_{jt} + \beta_2 \text{LTOTASST}_{jt} + \beta_3 \text{DEBTEQUT}_{jt} + \epsilon_{jt} \quad \text{(Model II)}
\]

\[
PAYOUT_{jt} = \gamma_0 + \gamma_1 \text{SALARY}_{jt} + \gamma_2 \text{LTOTASST}_{jt} + \gamma_3 \text{DEBTEQUT}_{jt} + \epsilon_{jt} \quad \text{(Model III)}
\]

\[
PAYOUT_{jt} = \delta_0 + \delta_1 \text{BONUS}_{jt} + \delta_2 \text{LTOTASST}_{jt} + \delta_3 \text{DEBTEQUT}_{jt} + \epsilon_{jt} \quad \text{(Model IV)}
\]

where

\[
\begin{align*}
PAYOUT_{jt} & = \text{Dividend payout (dividend/earnings) of firm } j \text{ in period } t; \\
\text{TOTCOMP}_{jt} & = \text{Total compensation to the CEO of firm } j \text{ in period } t \text{ in } \text{ millions}; \\
\text{OPTCOMP}_{jt} & = \text{Black-Scholes value of option grants to the CEO of firm } j \text{ in period } t \text{ in } \text{ millions}; \\
\text{SALARY}_{jt} & = \text{Total Salary to the CEO of firm } j \text{ in period } t \text{ in } \text{ millions}; \\
\text{BONUS}_{jt} & = \text{Total bonus to the CEO of firm } j \text{ in period } t \text{ in } \text{ millions}; \\
\text{LTOTASST}_{jt} & = \text{Log of Total Assets of firm } j \text{ in period } t \text{ in } \text{ millions}; \\
\text{DEBTEQUT}_{jt} & = \text{Total long-term-debt divided by total equity of firm } j \text{ in period } t.
\end{align*}
\]

The coefficient on TOTCOMP in Model I is negative and statistically significant at the 1% level. Ceteris paribus, every $1 million increase in total compensation reduces dividend payout ratio by 0.033.

Models II, III and IV in Table 3 show that dividend payouts are also negatively associated with option compensation, salary and bonus. The coefficients on OPTCOMP, SALARY and BONUS are all negative and statistically significant at the 1% level. Ceteris paribus, every $1 million increase in OPTCOMP reduces dividend payout by 0.0329, while every $1 million increase in
SALARY reduces dividend payout by 0.13. Bonus payments also influence dividend payout ratio. Every $1 million increase in BONUS reduces dividend payout by 0.18. The negative association between option grants and dividend payouts is consistent with Fenn and Liang (2001). However, we are not aware of any study that documents a negative association between salary and dividend payouts and between bonus and dividend payouts.

The control variables in our study include size (as measured by the log of total assets) and leverage (as measured by the ratio of long term debt to total equity). The coefficients for the size term and leverage term are significant and positive at customary levels of significance in all four regression models, indicating that larger, more highly levered firms pay out a higher proportion of their earnings in dividends.

In order to further our understanding of the relationship between the components of compensation, we estimate the following two regression models, with results shown in Table 4:

\[
\text{SALARY}_t = \lambda_0 + \lambda_1 \text{OPTCOMP}_t + \lambda_2 \text{LTOTASST}_t + \lambda_3 \text{DEBTEQUT}_t + \varepsilon_t \quad \text{and}
\]

\[
\text{BONUS}_t = \tau_0 + \tau_1 \text{OPTCOMP}_t + \tau_2 \text{LTOTASST}_t + \tau_3 \text{DEBTEQUT}_t + \varepsilon_t
\]

We find that salary and bonus are positively and significantly associated with option compensation. A CEO getting an additional $1 million in option grants will also get an additional $0.07 million in salary and $0.1 million in bonus. We also find that larger firms pay their CEOs greater amounts of cash compensation.
Discussion and Conclusion

As hypothesized, we find firms’ dividend payouts to be negatively associated with total managerial compensation. This is consistent with the argument that managers with lower productivity distribute more of their available earnings or cash as dividends because they do not have sufficient positive NPV projects, and shareholders use the compensation contract to induce these managers to distribute excess cash as dividends. In contrast, managers with high productivity have many more positive NPV projects, and therefore invest more of their available earnings or cash in productive ventures, leaving less for distribution as dividends. Consequently, dividend payout is negatively associated with managerial productivity. Assuming that higher productivity managers are paid more in an efficient labour market, it follows that dividend payouts will be negatively associated with managerial compensation. We find that this is indeed the case for our sample of US firms.

Dividend payouts are also negatively associated with stock options, salary and bonus. The stock option result corroborates the findings of Fenn and Liang (2001), while we are unaware of any study finding the salary and bonus results.

We also find a strong positive association between salary and option compensation and between bonus and option compensation. This suggests that information rents paid to managers may be partly in the form of stock options, perhaps because options offer accounting, tax and cash flow advantages to the firms.
Notes

1. Three other paradigms are used in understanding the dividend puzzle (Black, 1976) - the tax clientele theory (Miller & Modigliani, 1961), the signalling theory (Bhattacharyya, 1979; Miller & Rock, 1985; Williams, 1988; John et al., 1985; Heinkel, 1978)) and the free cash flow hypothesis (Easterbrook, 1984; Jensen, 1986)). In the tax clientele theory, investors, in equilibrium, select their portfolios optimally with reference to their marginal tax rates. A change in dividends will induce a churning in the capital market as investors trade and rebalance their portfolios. In signalling theory, insider managers signal their private information with dividends. In the free cash flow hypothesis, increasing dividends will mean removing money from the discretionary spending by managers who otherwise might invest the same money in negative Net Present Value (NPV) projects. All of these three theories about dividend policy are silent on the link to executive compensation.

2. In order to check the robustness of our results, we ran robust regressions for all regression equations. The results are qualitatively similar to the ones reported in the paper.
References


Table 1: Descriptive Statistics

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Notes:

This table presents the summary statistics for our sample of firm-years. The variables are defined as follows:

- **PAYOUT**: Dividend payout (dividend/earnings) of firm j in period t.
- **TOTCOMP**: Total compensation to the CEO of firm j in period t in $thousands.
- **OPTCOMP**: Black-Scholes value of option grants to the CEO of firm j in period t in $thousands.
- **SALARY**: Total Salary to the CEO of firm j in period t in $thousands.
- **BONUS**: Total bonus to the CEO of firm j in period t in $thousands.
- **DIVIDEND**: Dividends paid by firm j in period t to its common shareholders in $millions.
- **INCOME**: Net Income of firm j in period t in $millions.
- **TOTASSET**: Total Assets of firm j in period t in $millions.
- **TOTEQUIT**: Total Equity of firm j in period t in $millions.
- **LTD**: Total Long-Term-Debt of firm j in period t in $millions.
- **DEBTEQUT**: Total long-term-debt divided by total equity of firm j in period t.
### Table 2: Correlation Matrices

#### Panel A: Pearson Correlations

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Notes:

This table describes the correlations between the variables for our sample of 1621 firm-years. The variables are defined as follows:

- **PAYOUT** = Dividend payout (dividend/earnings) of firm \( j \) in period \( t \).
- **TOTCOMP** = Total compensation to the CEO of firm \( j \) in period \( t \) in $thousands.
- **OPTCOMP** = Black-Scholes value of option grants to the CEO of firm \( j \) in period \( t \) in $thousands.
- **SALARY** = Total Salary to the CEO of firm \( j \) in period \( t \) in $thousands.
- **BONUS** = Total bonus to the CEO of firm \( j \) in period \( t \) in $thousands.
- **DIVIDEND** = Dividends paid by firm \( j \) in period \( t \) to its common shareholders in $millions.
- **INCOME** = Net Income of firm \( j \) in period \( t \) in $millions.
- **TOTASSET** = Total Assets of firm \( j \) in period \( t \) in $millions.
- **TOTEQUIT** = Total Equity of firm \( j \) in period \( t \) in $millions.
- **LTD** = Total Long-Term-Debt of firm \( j \) in period \( t \) in $millions.
- **DEBTEQUT** = Total long-term-debt divided by total equity of firm \( j \) in period \( t \).
Panel B: Spearman Rank Correlations

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<th>BONUS</th>
<th>DIVIDEND</th>
<th>INCOME</th>
<th>TOTASSET</th>
<th>TOTEQUIT</th>
<th>LTD</th>
<th>DEBTEQUT</th>
</tr>
</thead>
<tbody>
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<td>PAYOUT</td>
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<tr>
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<tr>
<td>OPTCOMP</td>
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<tr>
<td>SALARY</td>
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<tr>
<td>BONUS</td>
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<td>0.35</td>
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</tr>
<tr>
<td>DIVIDEND</td>
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<td>0.17</td>
<td>0.08</td>
<td>0.24</td>
<td>0.11</td>
<td>1</td>
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<td>INCOME</td>
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<td>0.20</td>
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<td>0.38</td>
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<td>TOTASSET</td>
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<td>0.23</td>
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<td>0.66</td>
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<tr>
<td>TOTEQUIT</td>
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<td>0.21</td>
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<td>0.30</td>
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</tr>
<tr>
<td>LTD</td>
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<td>0.12</td>
<td>0.18</td>
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<td>0.15</td>
<td>0.13</td>
<td>0.60</td>
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</tr>
<tr>
<td>DEBTEQUT</td>
<td>0.07</td>
<td>-0.02</td>
<td>0.04</td>
<td>0.05</td>
<td>-0.05</td>
<td>-0.04</td>
<td>-0.13</td>
<td>0.33</td>
<td>-0.03</td>
<td>0.92</td>
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</tr>
</tbody>
</table>

Notes:

This table documents the Spearman rank correlation coefficients between various variable for our sample of 1621 firm-years. The variables are defined as follows:

- **PAYOUT** = Dividend payout (dividend/earnings) of firm j in period t.
- **TOTCOMP** = Total compensation to the CEO of firm j in period t in $thousands.
- **OPTCOMP** = Black-Scholes value of option grants to the CEO of firm j in period t in $thousands.
- **SALARY** = Total Salary to the CEO of firm j in period t in $thousands.
- **BONUS** = Total bonus to the CEO of firm j in period t in $thousands.
- **DIVIDEND** = Dividends paid by firm j in period t to its common shareholders in $millions.
- **INCOME** = Net Income of firm j in period t in $millions.
- **TOTASSET** = Total Assets of firm j in period t in $millions.
- **TOTEQUIT** = Total Equity of firm j in period t in $millions.
- **LTD** = Total Long-Term-Debt of firm j in period t in $millions.
- **DEBTEQUT** = Total long-term-debt divided by total equity of firm j in period t.
Table 3: Regression Results with Dividend Payout as Dependent Variable.

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Model I</th>
<th>Model II</th>
<th>Model III</th>
<th>Model IV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.19269***</td>
<td>0.22143***</td>
<td>0.20184***</td>
<td>0.16260***</td>
</tr>
<tr>
<td></td>
<td>(3.866)</td>
<td>(4.503)</td>
<td>(4.355)</td>
<td>(3.521)</td>
</tr>
<tr>
<td>Total Compensation</td>
<td>-0.032999***</td>
<td>-0.032918***</td>
<td>-0.13157***</td>
<td>-0.17555***</td>
</tr>
<tr>
<td></td>
<td>(-6.417)</td>
<td>(-4.439)</td>
<td>(-4.903)</td>
<td>(-8.294)</td>
</tr>
<tr>
<td>Option Compensation</td>
<td></td>
<td>-0.032918***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(-4.439)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salary</td>
<td></td>
<td></td>
<td>-0.13157***</td>
<td>-0.17555***</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(-4.903)</td>
<td>(-8.294)</td>
</tr>
<tr>
<td>Bonus</td>
<td></td>
<td></td>
<td></td>
<td>-0.17555***</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(-8.294)</td>
</tr>
<tr>
<td>Log (Total Assets)</td>
<td>0.024891***</td>
<td>0.01539*</td>
<td>0.025256***</td>
<td>0.031396***</td>
</tr>
<tr>
<td></td>
<td>(2.885)</td>
<td>(1.849)</td>
<td>(3.117)</td>
<td>(3.936)</td>
</tr>
<tr>
<td>Debt-Equity Ratio</td>
<td>0.0058145**</td>
<td>0.0062594***</td>
<td>0.0069697***</td>
<td>0.0063399***</td>
</tr>
<tr>
<td></td>
<td>(2.558)</td>
<td>(2.585)</td>
<td>(2.728)</td>
<td>(2.631)</td>
</tr>
<tr>
<td>R²</td>
<td>0.032</td>
<td>0.0154</td>
<td>0.0174</td>
<td>0.0563</td>
</tr>
<tr>
<td>F-Value</td>
<td>17.809***</td>
<td>8.447***</td>
<td>10.569***</td>
<td>35.645***</td>
</tr>
<tr>
<td>Number of Observations (N)</td>
<td>1622</td>
<td>1621</td>
<td>1795</td>
<td>1795</td>
</tr>
</tbody>
</table>

* significant at 10%  ** significant at 5%  *** significant at 1%

Notes:
PAYOUTᵢ = α₀ + α₁ TOTCOMPᵢ + α₂ LTOTASSTᵢ + α₃ DEBTEQUTᵢ + εᵢ  (Model I)
PAYOUTᵢ = β₀ + β₁ OPTCOMPᵢ + β₂ LTOTASSTᵢ + β₃ DEBTEQUTᵢ + εᵢ  (Model II)
PAYOUTᵢ = γ₀ + γ₁ SALARYᵢ + γ₂ LTOTASSTᵢ + γ₃ DEBTEQUTᵢ + εᵢ  (Model III)
PAYOUTᵢ = δ₀ + δ₁ BONUSᵢ + δ₂ LTOTASSTᵢ + δ₃ DEBTEQUTᵢ + εᵢ  (Model IV)

(t-ratios in brackets).
The variables are defined as follows:
PAYOUT = Dividend payout (dividend/earnings) of firm j in period t.
TOTCOMP = Total compensation to the CEO of firm j in period t in $millions.
OPTCOMP = Black-Scholes value of option grants to the CEO of firm j in period t in $million.
SALARY = Total Salary to the CEO of firm j in period t in $millions.
BONUS = Total bonus to the CEO of firm j in period t in $millions.
LTOTASST = Log of Total Assets of firm j in period t in $millions.
DEBTEQUT = Total long-term-debt divided by total equity of firm j in period t.
### Table 4: Regression Results with Salary and Bonus as Dependent Variables

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Salary</th>
<th>Bonus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>-0.012147 (0.2350)</td>
<td>-0.22*** (-3.614)</td>
</tr>
<tr>
<td>Option Compensation</td>
<td>0.071327*** (3.982)</td>
<td>0.10135*** (4.393)</td>
</tr>
<tr>
<td>Log (Total Assets)</td>
<td>0.063526*** (7.165)</td>
<td>0.077571*** (7.101)</td>
</tr>
<tr>
<td>Debt-Equity Ratio</td>
<td>-0.0018967 (-1.040)</td>
<td>-0.0038191 (-0.8635)</td>
</tr>
<tr>
<td>R²</td>
<td>0.1491</td>
<td>0.1082</td>
</tr>
<tr>
<td>F-Value</td>
<td>94.941***</td>
<td>65.709***</td>
</tr>
</tbody>
</table>

| Number of Observations (N) | 1629 | 1629 |

* significant at 10%  ** significant at 5%  *** significant at 1%

**Notes:**

The following models are estimated:

\[
\text{SALARY}_t = \lambda_0 + \lambda_1 \text{OPTCOMP}_t + \lambda_2 \text{LTOTASST}_t + \lambda_3 \text{DEBTEQUT}_t + \varepsilon_t
\]

\[
\text{BONUS}_t = \tau_0 + \tau_1 \text{OPTCOMP}_t + \tau_2 \text{LTOTASST}_t + \tau_3 \text{DEBTEQUT}_t + \varepsilon_t
\]

(t-ratios in brackets)

The variables are defined as follows:

- **OPTCOMP** = Black-Scholes value of option grants to the CEO of firm j in period t in $million.
- **SALARY** = Total Salary to the CEO of firm j in period t in $millions.
- **BONUS** = Total bonus to the CEO of firm j in period t in $millions.
- **LTOTASST** = Log of Total Assets of firm j in period t in $millions.
- **DEBTEQUT** = Total long-term-debt divided by total equity of firm j in period t.