



Research Paper

Research note: Investor perceptions of comparable-to-industry versus higher-than-industry pay ratio disclosures

Khim Kelly^{a,*}, Jean Lin Seow^b^a Kenneth G. Dixon School of Accounting, University of Central Florida, 12744 Pegasus Dr, Orlando, FL, 32816, United States^b Singapore Management University, 60 Stamford Road, Room 5002, 178900, Singapore

ARTICLE INFO

Keywords:

CEO compensation disclosure
 CEO-to-employee pay ratio
 Investor perceptions

ABSTRACT

The usefulness of the CEO-to-employee pay ratio disclosure to investors is subject to significant debate. Our experiment examines participant responses to higher-than-industry and comparable-to-industry pay ratio disclosures in a company. A prior experiment by Kelly and Seow (2016) (hereafter KS) found that incrementally disclosing a higher-than-industry pay ratio on top of higher-than-industry CEO pay had indirect negative effects on the company's perceived investment potential, via negative perceptions about the fairness of the CEO pay and workplace climate. We find that the negative indirect effects of pay ratio disclosures on perceived investment potential in KS are replicable in our study, and for a less extreme comparable-to-industry pay ratio. We do not find evidence that the effects of incremental pay ratio disclosure on investor perceptions are stronger when the pay ratio is higher-than-industry than when it is comparable-to-industry. Our study suggests that the ability of pay ratio disclosures to impact investor perceptions extends across a range of pay ratios.

1. Introduction

The U.S. Securities and Exchange Commission (SEC) recently finalized the pay ratio disclosure rule under Section 953 (b) of the Dodd-Frank Act, which stipulates that companies must disclose the pay of the median employee and the ratio between the pay of the CEO and that of the median employee (hereafter, pay ratio) with effect from 2017 (SEC, 2015). However, the usefulness of pay ratio disclosures to investors is subject to substantial debate (e.g., American Benefits Council, 2012; Trumka, 2010; Warren, 2010; Wartzman, 2011). Some argue that it is not clear how pay ratio disclosures would be useful to investors because “the ratio will inevitably vary widely across industries or businesses without any relevance to the financial performance of a company” (American Benefits Council, 2012). Therefore, to better understand the usefulness of pay ratio disclosures to investors, it is important to examine how investors process pay ratio variations that reveal different degrees of pay inequity between the CEO and the median employee.

Kelly and Seow (2016) (hereafter KS) use an experiment with Singapore MBA students acting as investors and find that incremental higher-than-industry pay ratio disclosure (versus higher-than-industry CEO pay disclosure only) has indirect negative effects on perceived investment potential through perceived CEO pay fairness and perceived workplace climate.¹ This research note extends KS by examining investor responses to pay ratio variations.² Specifically, we test whether the effects in KS for a higher-than-industry pay ratio are also observable for a less extreme comparable-to-industry pay ratio and whether the effects are stronger for a higher-than-industry pay ratio disclosure than a comparable-to-industry pay ratio disclosure.³

We find that incremental disclosure of pay ratio, regardless of whether it is comparable-to-industry or higher-than-industry, has indirect negative effects on perceived investment potential through perceived workplace climate and perceived CEO pay fairness. We find no evidence to support our hypotheses that the effects of incremental pay ratio disclosure on investor perceptions are stronger when the pay ratio

* Corresponding author.

E-mail addresses: Khim.Kelly@ucf.edu (K. Kelly), jeanseow@smu.edu.sg (J.L. Seow).

¹ Using the full sample of participants, KS reports a significant indirect negative effect via perceived CEO pay fairness and an insignificant indirect negative effect via perceived workplace climate. However, using a smaller sample of participants who passed the manipulation checks, KS reports in their Footnote 22 a marginally significant indirect negative effect via perceived CEO pay fairness and a significant indirect negative effect via perceived workplace climate. Regardless of the sample KS uses, the overall inference is that there are indirect negative effects on perceived investment potential from an incremental higher-than-industry pay ratio disclosure.

² We set our experiment in a restaurant industry, different from the semiconductor industry in KS to increase the likelihood that investors would respond to pay ratio variations as a result of perceived CEO pay fairness and perceived workplace climate. The restaurant industry that we use presents a setting where rank and file employees have direct contact with customers and personalized customer service is important for the business strategy, which may heighten the effects of perceived CEO pay fairness and workplace climate.

³ We do not examine how participant perceptions are affected by the disclosure of a lower-than-industry pay ratio.

<http://dx.doi.org/10.1016/j.mar.2017.09.002>

Received 4 August 2016; Received in revised form 1 September 2017; Accepted 22 September 2017
 1044-5005/ © 2017 Elsevier Ltd. All rights reserved.

is higher-than-industry than when it is comparable-to-industry.

Given that companies care about the ramifications arising from negative perceptions of investors and the public when pay ratio disclosures are made (Greene, 2014), our study suggest that pay ratio disclosures could help restrain CEO pay by highlighting how much more the CEO is paid relative to the average employee (Aguilar, 2013; Menendez et al., 2014). Our results indicate that even disclosing a comparable-to-industry pay ratio has similar negative effects on investor perceptions as disclosing a higher-than-industry pay ratio, which suggest that these negative effects are driven by the comparison of the CEO pay to the median employee pay, regardless of whether the pay ratio is comparable-to-industry or higher-than-industry. Hence, the need for companies to manage investor perceptions is not limited to those disclosing pay ratios that are higher than industry norms, but extends even to those disclosing pay ratios that are in line with industry norms. Our findings complement the survey results in Larcker et al. (2016) which suggest that actual pay ratios and CEO pay are much higher than what the majority of their respondents believe them to be. As such, even a comparable-to-industry pay ratio may still violate people's expectations of what would be fair and appropriate. The negative investor perceptions associated with pay ratio disclosure, even when the pay ratio is comparable-to-industry, may discourage companies from continually increasing their CEO pay to keep up with industry benchmarks of CEO pay.

We organize the rest of this research note in the following manner. We first discuss the hypotheses. We then describe the design of the experiment, followed by the results. Lastly, our study's findings and limitations are discussed in the conclusion.

2. Theory and hypothesis development

We argue that incremental disclosure of pay ratio, whether it is comparable-to-industry or higher-than-industry, would have indirect negative effects on perceived investment potential through both perceived CEO pay fairness and perceived workplace climate. KS finds support for similar hypotheses for incremental higher-than-industry pay ratio disclosure. We further argue that these indirect negative effects are stronger under a higher-than-industry pay ratio than a comparable-to-industry pay ratio. We develop our hypotheses, depicted in Fig. 1 Panel A, as follows.

First, Hypothesis 1a predicts that incremental disclosure of pay ratio, whether it is comparable-to-industry or higher-than-industry,

negatively impacts perceived CEO pay fairness. Hypothesis 1a is based on equity theory (Adams, 1965) and social norms that people hold about fair allocation of resources (Elster, 1989; Kahneman et al., 1986). Under equity theory, the fairness of a person's pay is evaluated by comparing that person's pay outcomes and work inputs with those of other persons, and a ratio of outcomes to inputs that is comparatively larger than that of others is then deemed as unfair (Adams, 1965). Prior research suggests people may perceive inequity when there is large vertical pay dispersion between lower-level employees and higher-level employees (e.g., Cowherd and Levine, 1992). A pay ratio that makes salient that the CEO is paid substantially more than the median employee in the company may lead investors to perceive that the CEO is receiving a higher ratio of outcomes to inputs than would be fair.

There is reason to believe that there may be a stronger negative effect on perceived CEO pay fairness when the pay ratio is higher-than-industry than when it is comparable-to-industry (Hypothesis 1b). People naturally expect a CEO to be better paid than a median employee because the CEO provides more inputs, and thus a pay differential between the two is not necessarily perceived as unfair unless the differential is large enough (Becker, 1961; Gupta et al., 2012). The larger the pay differential, the greater the likelihood that the pay differential would be unexpected and hence perceived as unfair. Prior research indicates that fairness perceptions are influenced by external comparisons of pay in an organization with pay in other organizations (Shore et al., 2006). Thus, people may make an external comparison of the pay differential in one organization with that of peer organizations to benchmark their expectations. Investors may respond more negatively to a higher-than-industry pay ratio disclosure than a comparable-to-industry pay ratio disclosure because the former reveals a greater pay disparity that is more likely to be out of line with investors' expectations. However, the current public perception surrounding the pay disparity between CEOs and average employees is very negative (Larcker et al., 2016). In a survey of 1202 individuals across the U.S., Larcker et al. (2016) find that 74% of respondents believe that CEO pay relative to the average worker's pay is inappropriate, and 62% believe that CEO pay should be capped at a mean of 17.6 times of the average worker's pay, which is much lower than current pay multiples of about 210. As such, even a comparable-to-industry pay ratio disclosure making salient that the CEO is paid multiples of what the median employee earns may be sufficient to trigger perceptions of inequity as long as the pay ratio is higher than investors' expectation of a fair pay multiple.

Panel A: Effects of Incremental Disclosure of Pay Ratio on Perceived Investment Potential^a

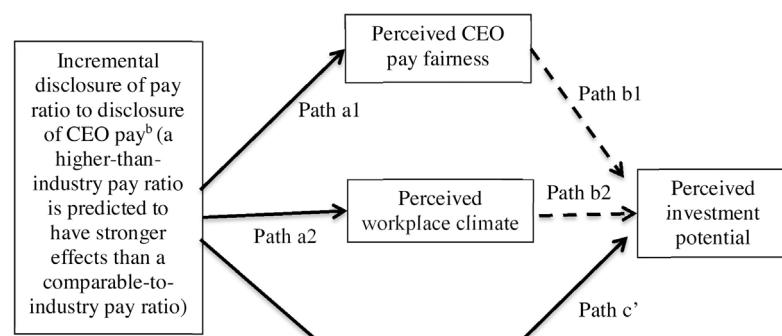


Fig. 1. Panel A: Effects of Incremental Disclosure of Pay Ratio on Perceived Investment Potential^a. Panel B: Experimental conditions, associated labels, and manipulations^b.

^a We test our hypotheses using mediation models in Tables 2 and 3. Path a1 (H1a) and Path a2 (H2a) represent the predicted negative effects of incremental pay ratio disclosure on each mediator. Path b1 and Path b2 represent the expected positive effects of each mediator on perceived investment potential and are represented with a dashed line in the figure to indicate that the effects had previously been tested in KS. Path a1*Path b1 (H3a) and Path a2*Path b2 (H3b) represent the predicted indirect negative effects of incremental pay ratio disclosure on perceived investment potential through each mediator. Path c' is the effect of incremental pay ratio disclosure on perceived investment potential after controlling for the mediators in the mediation models. We further predict that the effects in H1a, H2a, H3a, and H4a are stronger for a higher-than-industry pay ratio than a comparable-to-industry pay ratio in H1b, H2b, H3b, and H4b, respectively.

Download English Version:

<https://daneshyari.com/en/article/7413627>

Download Persian Version:

<https://daneshyari.com/article/7413627>

[Daneshyari.com](https://daneshyari.com)