ARTICLE IN PRESS

Journal of Accounting and Public Policy xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Journal of Accounting and Public Policy

journal homepage: www.elsevier.com/locate/jaccpubpol

Full length article

# Accounting and economic consequences of CEO paycuts☆

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ARTICLE INFO

*JEL classifications:*
G30
G32
M40
M42

*Keywords:*
Executive compensation
Pay cut
Earnings management
Agency theory

ABSTRACT

Boards sometimes cut a CEO's pay following poor performance. This study examines whether such CEO paycuts really work. We identify 1,496 instances of large CEO paycuts during the period 1994–2013. We then create a propensity-score-matched control group of firms that did not cut their CEOs' pay and employ a difference-in-differences approach to examine the consequences of paycuts. Our results show that, following a paycut, CEOs are likely to engage in earnings management in an attempt to accelerate improvement in the reported performance and to achieve a speedier restoration of their pay to pre-cut levels. Further, we find that improvement in long-term performance after a paycut occurs only for those firms with lower levels of earnings management after the paycut. Finally, we show that paycuts are more likely to lead to unintended value-destroying consequences in the absence of high institutional ownership or when the CEO is sufficiently entrenched, thereby impairing the effectiveness of internal monitoring by boards.

## 1. Introduction

Boards of directors (board) often cut CEO pay following poor performance[1] and these paycuts often go beyond the general pay-for-performance relation (Matsunaga and Park, 2001; Gao et al., 2012; Mergenthaler et al., 2012). Fama (1980) suggests that such paycuts can act as a mechanism for ex-post settling up by the CEO for his past performance, and therefore, can lead to decreased managerial agency costs and better performance in subsequent periods. Consistent with this line of reasoning, Gao et al. (2012) find that firm performance improves following a CEO paycut and conclude that a paycut is therefore an effective mechanism to motivate a poorly performing CEO.

However, it is possible that cutting the pay of an incumbent CEO might also induce an adverse response. CEO compensation contracts are generally based on stock price performance and accounting earnings numbers (Lambert and Larker, 1987; Sloan, 1993; Jackson et al., 2008). Multi-task agency theory (e.g., Holmstrom and Milgrom, 1991; Baker, 1992; Feltham and Xie, 1994) suggests that reliance on these performance measures as a proxy for the unobservable managerial effort can lead to distorted incentives, in the sense that a CEO can allocate effort inefficiently between productive and manipulative activities. Such manipulative activities include both accruals manipulation and real activities management, such as abnormal cuts in R&D expenditure, which will boost reported earnings in the short-run at the expense of long-term shareholder value. Following a paycut, it is possible for CEOs' incentives to

☆ We thank Daniel Cohen (AAA discussant), Sanjay Kallapur, MaryLea McAnally, Shiva Rajgopal, Lakshman Shivakumar, Paul Simko, K.R. Subramanyam, Dana Zhang, Joe Zhang, participants at the AAA annual meeting2014, and workshop participants at Indian School of Business for their helpful comments. An earlier version of this paper was circulated under the title "Do CEO pay cuts really work"?

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[1] In a recent WSJ article (March 20, 2013) Thurm documents several instances of a firm cutting its CEO's pay following poor performance.

https://doi.org/10.1016/j.jaccpubpol.2018.01.002

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engage in earnings management to increase because such activities can lead to faster improvement in reported performance, and hence, to speedier restoration of their pay to earlier levels. Thus, the effect of a paycut on a CEO's subsequent actions and the firm's future performance are unclear. In this study, we examine whether CEO paycuts really work both in the short run and long term.

To address our research question, we first identify 1496 instances of CEO paycuts from a sample of non-financial firms on Execucomp over the period 1994–2013. We classify a decrease in CEO pay as a "paycut" if the CEO's incentive compensation (i.e., bonus plus stock-based pay) that is not directly tied to performance is reduced by at least 25% from the previous year. By doing so, we are able to identify planned or deliberate paycuts arising from a revised contract as opposed to paycuts that follow as a consequence of poor performance based on an existing or prior managerial contract. We then use the propensity-score-matching (PSM) procedure to select a control sample that includes firms that did not initiate a CEO paycut, but are similar to the firms initiating a CEO paycut using factors that prior research has shown to be associated with a CEO paycut.

We then proceed to examine changes in earnings management before and after a CEO paycut for the firms that had a CEO paycut and benchmark these changes against this control sample. We consider both accruals-based and real activities-based earnings management in our analysis. We measure accruals-based earnings management as discretionary accruals calculated from the modified Jones model as formulated by Dechow, Sloan, and Sweeney (1995). We measure real earnings management as abnormal discretionary expenditure, following Roychowdhury (2006). Our analysis reveals a significant increase in the magnitude of discretionary accruals and abnormal discretionary expenditure after a CEO paycut compared to the period prior to the pay cut. The firms with a CEO paycut would have reported much lower profits in the year following the paycut had they not engaged in these earnings management activities. In contrast, we do not observe a similar increase in earnings management for the matched control firms.

We then examine cross-sectional variation in the proclivity of CEOs to manage earnings in the year following the pay cut. Prior research suggests that one role of corporate governance in financial reporting is to ensure compliance with financial accounting requirements and maintain the credibility of financial statements (Shleifer and Vishny, 1997; Core et al., 1999). We focus on the role of two particular features of corporate governance - CEO power vis-à-vis the board, and institutional ownership in the firm. We, find that the proclivity to manage earnings after a pay cut is higher for firms whose CEOs are more entrenched (as proxied by a higher *E-index*) because these CEOs are less likely to be constrained when their power relative to the board is greater. On the other hand, we find that the ability of CEOs to opportunistically manipulate earnings in the year after the paycut decreases in the presence of dedicated institutional ownership because more effective monitoring implied by dedicated institutional ownership inhibits CEOs from engaging in such opportunistic behavior (Bushee, 1998).

Finally, we examine the impact of paycuts on long-term profitability and risk. We find that one-year-ahead return on assets ($ROA_{t+1}$), cash flow from operations scaled by total assets ($CFO_{t+1}$), and stock returns increase after a CEO paycut (relative to the control sample), but only for those firms that have low levels of earnings management after paycut. In contrast, future performance is lower following a CEO paycut for firms that exhibit high levels of earnings management. These results also rule out the possibility that the earnings management proxies capture operational changes expected to happen after a CEO paycut rather than opportunistic CEO behavior to mask poor reported accounting performance in the short-run. We also find that one-year-ahead idiosyncratic return volatility increases (decreases) significantly after a CEO paycut (relative to the control sample) for firms that have high (low) levels of earnings management.

We consider two alternate explanations for our results. The first is that CEOs desire to have their pay restored to pre-paycut levels, and hence, manage earnings to achieve the accounting performance metric targets included in bonus and equity compensation contracts. In this case, it is difficult to link earnings management to the disciplining role of paycut as opposed to the CEO managing earnings to meet a given performance metric. We rule out this possibility by explicitly controlling for equity incentives in our difference-in-differences regression model. The second explanation is that the firm's poor performance provides incentives for earnings management. Poor performance can also lead to a CEO paycut. Thus, it may be the firm's poor performance and not the paycut per se that leads the CEO to engage in earnings management. However, our propensity score matching technique ensures that the treatment and control firms are similar along the performance dimensions. Thus, any observed differences in the level of earnings management after a paycut are more likely due to the paycut and not to differences in performance. Overall, our experimental design together with our evidence suggests that neither of these alternatives is a viable explanation for our results.

Our results raise two questions that require further explanation. First, why would a CEO engage in earnings management only after the board cuts his pay and not do so before the paycut? The CEO may have been able to avoid the paycut and other negative ramifications of poor performance by engaging in earnings management prior to the paycut. Second, why would a board that is able to cut the CEO's pay tolerate earnings management behavior, which imposes significant agency costs on the firm? These two questions are interrelated and are best explained by examining the firms' and managers' behavior both pre and post paycut periods in greater detail.

We posit that CEOs can time their earnings management so that they attract less scrutiny. The median ROAs of firms that cut CEO pay are 4.5%, 2.7% and 3.1% in the years $T-1$, $T$ and $T+1$, respectively, where $T$ is the year of CEO paycut. The median pre-managed ROAs for the corresponding years are 4.3%, 2.4%, and 2.2%, respectively. To show an improvement in ROA for year $T$ (the year of the paycut) over the ROA for year $T$-$1$, the pre-managed earnings needs to be bumped up by at least 88% [(4.5% − 2.4%)/ 2.4%]. This exceedingly high level of earnings management is likely to attract considerably more scrutiny when compared to earnings management in year $T+1$ (the year after the paycut) when the benchmark to beat is relatively low. Thus, if the CEO is powerful and can influence the pay-setting process (Bertrand and Mullainathan, 2001; Bebchuk and Fried, 2004; Laksmana et al., 2012), he can devise a less risky strategy. The CEO can accept a paycut in the period of poor performance to placate stakeholders, and subsequently have the board restore the pay to earlier levels when the firm's reported accounting performance improves, albeit via real activities and accruals earnings management. This tacit understanding between the board and the CEO can also explain why a board first cuts

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