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Board affiliation and pay gap

Shenglan Chen [a,*], Hui Ma [a], Danlu Bu [b]

[a] *Department of Accounting, School of Economics and Management, Inner Mongolia University, China*
[b] *Department of Accounting, Southwestern University of Finance and Economics, China*

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ABSTRACT

This paper examines the effects of board affiliation on the corporate pay gap. Using a sample of Chinese listed firms from 2005 to 2011, we find that boards with a greater presence of directors appointed by block shareholders have lower pay gaps. Furthermore, the governance effects of board affiliation with and without pay are distinguished. The empirical results show that board affiliation without pay is negatively related to the pay gap, while board affiliation with pay is positively related to the pay gap. Overall, the results shed light on how block shareholders affect their companies' pay gaps through board affiliation.

1. Introduction

Compensation packages are an important part of a modern company's incentive system. Most relevant research has focused on examining the level of executive pay and the different components of executive compensation, while ignoring further discussion about a company's pay gap. Originally, the pay-gap phenomenon could be chiefly explained by tournament theory. That is, an appropriate pay gap increases employee motivation and productivity. However, in recent years, company pay gaps have continuously widened, which appears to be due to company executives manipulating the formulation process of compensation to increase

* Corresponding author. Tel.: +86 13948107562.
E-mail address: chen_shenglan@126.com (S. Chen).

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their salaries beyond the optimal level (Bebchuk and Fried, 2003). According to the executive-power theory, executive misuse of their power to obtain excessive pay has a series of negative economic consequences, such as the failure of salary–incentive mechanisms and a decline in overall company performance (Bebchuk et al., 2011).

Within the ongoing development of the Chinese economy, the compensation received by executives in Chinese companies is increasing rapidly and company pay gaps are widening. For example, the 2010 annual report of China International Marine Containers (Group) Ltd. (stock code 000039) indicates that the company's largest compensation package of that year was 6.0 million RMB yuan, while its average annual employee wage was only 65,800 yuan. In 2011, the highest executive compensation reached 9.6 million yuan, while the average annual employee wage was only 78,600 yuan. The company's pay gap thus increased between 2010 and 2011, from a highest 90 times of the average employee pay, to a highest 121 times of the average employee pay. When considering the possible negative effect of the pay gap, it is necessary to determine whether the company's governance mechanisms are able to effectively reduce its pay gap and ease the agency problem during the process of formulating compensation packages.

In China's specific institutional setting, block shareholders are entitled to appoint personnel to listed companies as directors. This is one of the major ways for block shareholders to supervise company executives. Once the block shareholders of a company have realized that an agency problem is affecting the salary-setting process, they appoint certain personnel as company directors responsible for supervising executives' opportunistic behavior. However, the governance effect of board affiliation may differ substantially due to differences in receiving compensation. Currently, the directors appointed by block shareholders may either receive or not receive pay from the listed companies for which they work. Salaried directors appointed by block shareholders are more reliant than their non-salaried counterparts on the executives of the listed company, which may reduce director independence and thus impair the efficiency of their executive supervision. In contrast, non-salaried directors appointed by the block shareholders are more independent, better able to represent the interests of block shareholders to supervise executives, and ultimately achieve a better supervision effect. As a result, only non-salaried directors appointed by block shareholders can help significantly to ease the agency problem and reduce a company's pay gap.

Using a sample of Chinese A-share listed firms from the 2005–2011 period, we examine the effects of the company-governance mechanism of board affiliation on the pay gap. Following other studies on this topic, we interpret the pay gap between executives and employees, and the pay gap among executives as proxies for the pay gap (Bu and Peng, 2010; Banker et al., 2011; Kato and Long, 2011). We measure board affiliation using the ratio of the number of directors appointed by block shareholders to the total number of directors on the board (Yeh and Woidtke, 2005; Chen et al., 2013). We also examine the different roles of salaried and non-salaried directors appointed by block shareholders. We measure the proportion of salaried directors as the ratio of the number of salaried directors appointed by block shareholders to the total number of directors on the board. We measure the proportion of non-salaried directors as the ratio of the number of non-salaried directors appointed by block shareholders to the total number of directors on the board.

Consistent with our prediction, we find that board affiliation is negatively related to the pay gap. Furthermore, the results show that a greater presence of salaried directors appointed by block shareholders is associated with a higher pay gap, whereas a greater presence of non-salaried directors appointed by block shareholders is associated with a lower pay gap. These findings still hold when tested with a two-stage regression model, so endogeneity issues are less likely to bias our empirical findings.

Next, we investigate certain factors that may affect the relationship between board affiliation and the pay gap. We begin by examining whether differences in product market competition affect how board affiliation reduces the pay gap. If a firm uses its pay gap as an incentive mechanism and the product market is highly competitive, the salaried directors appointed by the firm's block shareholders will increase the pay gap to stimulate executives to work hard. However, under the same conditions, non-salaried directors appointed by block shareholders will decrease rather than increase the pay gap. We find that the governance effect of board affiliation on the pay gap is particularly prominent in industries in more competitive product markets.

Second, we investigate whether differences in ownership affect the extent that board affiliation reduces the pay gap. The results indicate no significant differences in the effects of salaried and non-salaried directors appointed by block shareholders on the pay gap between state-owned and non-state-owned enterprises. This