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Pay disparities within top management teams and earning management

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ABSTRACT

I examine the impact of pay disparity between the chief executive officer (CEO) and the next layer of executives in the top management team (TMT) on earnings management through real activities manipulation (RAM). I find that firms with larger pay disparities in the TMT exhibit more RAM and that the positive relation is driven by short-term compensation. The main findings are robust to corrections for endogeneity of all managerial incentive measures. I find some evidence that the positive relation between pay disparity and RAM is less pronounced for firms in homogeneous industries, while it is more pronounced for firms with CEO turnover in subsequent years. I also find that large pay disparity is associated with low future performance. Collectively, my evidence suggests that TMT pay disparity increases RAM by fostering extreme competition for advancement to the CEO position. This study provides useful insight into the distribution of executive pay and its effects on corporate earnings management behavior.

1. Introduction

The recent growth in pay disparity has led many to question whether the disparity negatively contributes to a company's long-term health. Excessive pay disparity has even developed between the CEO and executives at the next level down the corporate ladder.[1] Given that the nature of executive work requires a high degree of task interdependence, relational pay patterns among executives are expected to affect the functioning of top corporate management groups (Siegel and Hambrick, 2005). Prior studies document mixed evidence on performance implications of the pay distribution within the top management team (TMT). The goal of this paper is to provide evidence for a specific mechanism through which TMT pay disparity influences firm performance. My focus is on managerial earnings management behavior. More specifically, I examine how pay disparity between the CEO and other TMT executives impacts corporate real activities manipulation (RAM).

Because of the separation of ownership and control in publicly traded corporations, it is of paramount importance to understand how internal incentive structures determine the behavior of individuals inside an organization (Baker et al., 1988). While executive compensation schemes can encourage managers to exert costly efforts to maximize shareholder value, they can also induce managers to manipulate reported earnings in an attempt to avoid adverse compensation and career consequences. Prior research has focused on the relation between performance-based compensation for individual executives and earnings management (e.g., Healy, 1985; Guirdy et al., 1999; Cheng and Warfield, 2005; Bergstresser and

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[1] For example, in 2008 the Connecticut Retirement Plans and Trust Funds filed shareholder resolutions at Abercrombie & Fitch and SuperValu that would require the companies to adopt policies to encourage greater pay equity between the CEO and other named executive officers (Larcker and Tayan, 2013).

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Philippon, 2006; Burns and Kedia, 2006; Jiang et al., 2010; Duellman et al., 2013). Yet most of the average increases in compensation occur through promotion rather than through continued service in a given position (e.g., Medoff and Abraham, 1980; Baker et al., 1988; Eriksson, 1999; Bognanno, 2001). Pay disparity between the CEO and the next-highest executives is particularly large (e.g., Lambert et al., 1993). Despite the importance of the potential incentives produced by this kind of pay disparity, we know little about their effects on managerial earnings management behavior.

The academic literature has not reached a consensus on how the executive pay distribution influences firm performance. Some, particularly those based on tournament theory, argue that pay disparity has a positive effect on firm performance because it incentivizes executives to work hard in order to increase their probability of advancement (e.g., Eriksson, 1999; Lin et al., 2013; Kale et al., 2009; Ridge et al., 2015). However, others argue that pay disparity among executives has a negative effect on performance (e.g., Henderson and Fredrickson, 2001; Bebchuk et al., 2011). A large tournament prize, combined with the convexity feature of the promotion tournament, fosters extremely aggressive and competitive behavior, which in turn reduces firm value (e.g., Siegel and Hambrick, 2005). Pay disparity between the CEO and other executives in the TMT also creates both substantive and perceptual barriers between levels (e.g., Cowherd and Levine, 1992). Such barriers can cause strategic error and poor firm performance. In this study, I investigate this issue by exploring an economic mechanism through which pay disparity relates to firm performance.

The focus of this paper is on how pay disparity between the CEO and other TMT executives is associated with a firm's RAM, in which executives manipulate the timing or structuring of real operations.[2] Specifically, I argue that large pay disparity in the TMT is associated with high levels of RAM for three major reasons. First, accrual-based earnings management that requires sophisticated accounting and finance expertise is likely to be limited to chief financial officers (CFOs) or CEOs (e.g., Jiang et al., 2010). Daily operational decisions, however, are carried out and overseen by most TMT executives. Even though these executives may not be directly responsible for generating corporate strategies, implementation at the operational level is largely left to their discretion and they set the culture in which daily operations will function. Second, true managerial abilities are unobservable and must be inferred through reported performance. Given the relative performance evaluation scheme of promotion (e.g., Lazear, 1989; Gibbs, 1995) and the difficulty in detecting RAM by boards (e.g., Kim and Sohn, 2013), large TMT pay disparities can create incentives for executives to inflate reported performance by engaging in RAM to increase their chances of promotion.[3] Third, a concentration of power with the CEO is likely to result in a breakdown of good governance (e.g., Adams et al., 2005; Bebchuk et al., 2011), and powerful CEOs have greater incentives to maintain their status and reputation as high performers (e.g., Mande and Son, 2012). Thus, dominant CEOs who receive high compensation relative to other TMT executives could push TMT executives to engage in RAM for their own stock market or career incentives.

My baseline tests show that, on average, pay disparity between the CEO and other TMT executives is positively associated with RAM. In particular, short-term pay disparity, which provides TMT executives with more immediate and less risky financial gains upon promotion to the CEO position, is positively related to RAM. A major challenge of my study is to establish the causal effect of TMT pay disparity on a firm's RAM due to potential endogeneity problems. To alleviate the concerns, I investigate the effect of lagged TMT pay disparity on current RAM, include an extensive set of control variables, use a fixed effects approach, and employ two-stage least squares (2SLS) regression models (e.g., Kini and Williams, 2012), two-stage Heckman models (e.g., Cohen and Zarowin, 2010), and simultaneous equations (e.g., Coles et al., 2006; Kini and Williams, 2012). I find consistent results across different identification strategies. Furthermore, I find that pay disparity between the CEO and the CFO (non-CFO TMT executives) is positively related to accrual-based earnings management (RAM), consistent with the notion that an increase in pay given upon promotion to the CEO position provides CFOs with incentives to choose accrual-based earnings management, while such an increase provides non-CFO TMT executives with incentives to engage in RAM.

To gain a clearer understanding of these results, I examine whether the link between TMT pay disparity and RAM varies across firms. First, external employment opportunities are greater in a homogeneous industry (e.g., Gao et al., 2015), which in turn decreases incumbent TMT executives' incentives to win internal promotion. Second, the perceived probability of immediate promotion is greater for executives in firms where CEO turnover is likely in the next few years (e.g., Kale et al., 2009), which in turn increases incumbent TMT executives' incentives to win internal promotion. Indeed, I find some evidence that the positive relation between short-term pay disparity and RAM is less pronounced for firms in homogeneous industries and that the relation between long-term pay disparity and RAM becomes significantly positive for firms that experience CEO turnover in two years. On the other hand, I find little evidence that the relation between pay disparity and RAM is driven by powerful CEOs, which are measured by CEO duality and CEO tenure. These results are consistent with the argument that TMT pay disparity increases RAM at least in part by promoting extreme succession tournaments. Lastly, large pay disparity is associated with low future performance, which can be explained by pay disparity encouraging aggressive operating decisions rather than the efficient contracting argument.

[2] Examination of RAM is important because previous studies suggest that firms use RAM as an alternative tool for earnings management (e.g., Roychowdhury, 2006; Cohen et al., 2008; Cohen and Zarowin, 2010; Zang, 2012; Kim and Park, 2014).

[3] In particular, large pay disparity within an organization is likely to have a harmful effect when the personalities of the workers suggest that they are prone to aggressive self-promotion at the cost of others (Lazear's "hawks", Lazear, 1989). Given that top executives are highly motivated, achievement-oriented, power-seeking, status-driven, and overconfident (e.g., Lazear, 1989; Malmendier and Tate, 2005; Goel and Thakor, 2008; Fredrickson et al., 2010), large pay disparities can result in their suboptimal behavior.