Managers' Pay Duration and Voluntary Disclosures

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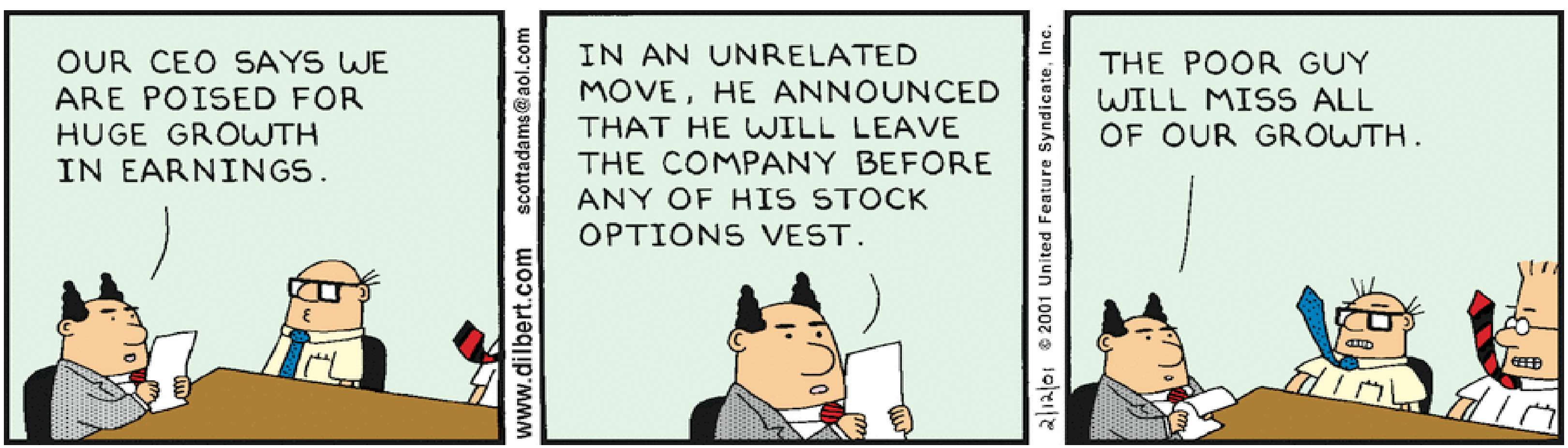

Big Picture Motivation

?

Managers' pay duration

Why is this interesting?

- Vesting periods of stock grants and option grants are important design features of CEO/executive compensation.
- A quantifiable metric of "short-termism" – weighted average vesting period of compensation components

Voluntary Disclosures

Why is this interesting?

- Discretionary disclosures and various "misreporting" behaviors – a central theme in accounting research and practice.

Highlights of the paper

Strengths: well written, well executed empirical paper.

Determinants of pay duration

- Firm characteristics (MTB, Size, return volatility, stock price performance, governance characteristics, …)
- Replicates findings in Gopalan et al. (JF 2014), Cadman et al. (RAST 2013).

Consequences of pay duration

- Firms with longer CEO pay duration <u>are more likely</u> to issue "bad news" earnings forecasts (and more accurate forecasts).
- About 10% more likely – as duration goes from 1st to 3rd quartile.
- Interpretation?? Increasing pay duration is a "good thing" – motivates more forthcoming disclosures.

What is the "assumed" theory – step 1

Separation of management & control problem(s)

Moral hazard and adverse selection

- Rents due to private information (e.g., managerial ability)
- Hiring, matching
- Job security, mobility, retention
- Perquisite consumption
- Shirking
- "career concerns"
- "short-termism"

Consequences →

Managerial decisions

Production/ Investment

Financing

and Reporting

- Non-disclosure
- Selective disclosure of private info; e.g., disclose more good news than bad news
- Ex-post "earnings management" – inflation, deflation, smoothing,…

What is the theory – step 2

Control Problem(s)

Moral hazard and adverse selection

- **Rents due to private information**
- **Hiring, matching**
- **Job security, mobility, retention**
- **Perquisite consumption**
- **Shirking**
- **“career concerns”**
- **“short-termism”**

MECHANISMS

Consequences

1. **Observation and monitoring by outsiders or insiders (e.g., institutional investors, boards)**
2. **Legal / regulatory**
   Litigation, audits, ex-post settling up
3. ***** Compensation contracts *****

Managerial decisions

Production / Investment

Financing

and Reporting

- **Non-disclosure**
- **Selective disclosure of private info; e.g., disclose more good news than bad news**
- **Ex-post “earnings management” – inflation, deflation, smoothing,…**

Compensation contracts as mechanisms that alleviate control problems

Features / elements:

- *Types of payments*; cash, non-cash, severance pay, salary, bonus, stock, options, pensions, benefits,…
- *Performance contingency*; choice of performance measures, targets, performance-period, pay-for-performance sensitivity, …
- *Other – e.g., vesting period* – as distinct (say) from "performance period."

Key questions in literature:

Conceptual: Which compensation feature (or combination of features) is best suited to address which control problem?

Empirical: How to identify / isolate determinants and consequences of individual compensation features?

Cheng et al. paper *– entry into the literature*

- Control problem: *"Short-termism"*
- Executives are short-term oriented; firms prefer "longer" term orientation
- Why? Executives concerned about job security, future (lifetime) wages, compensation risk, portfolio risk, etc.,
- Prescribed remedy: extend pay-duration (weighted average vesting period) – claimed to best address short-termism.
- Comparison to other remedies?

  (i) Why not severance pay? – parachute rather than a handcuff!

  (ii) alternative performance measures (and performance periods)?

  (iii) Levels of incentive pay based on stock and options? – assumed necessary but insufficient to motivate longer-term orientation.

Cheng et al. paper

First stage:

Document the determinants of pay duration

- **OLS regression:**

  Pay Duration = function [firm, CEO, governance,…]

- Well done; wide variety of proxies, robustness tests,…
- Findings consistent with (largely replicate) Gopalan et al (2014), Cadman et al (2013). - MTB, size, performance, volatility, governance, …
- **One (measurement) Question?**

  Pay duration vs Vesting period vs Performance period?

Cheng et al. paper

<u>Second stage:</u>

- **Document the <u>consequences</u> of pay duration**
  - <u>Hypothesis</u>: Firms with longer CEO pay duration <u>are more likely</u> to "do the right thing"
  - Right thing? Better production/investment/financing decision, better disclosure/reporting decisions

- **Probit:** *Likelihood of Bad News Forecast = function[pay duration, …]*
  +
- **OLS:** *Accuracy of Bad News Forecast = function[pay duration, …]*
  +

- Cross- sectional tests – for substitute non-compensation mechanisms:

  \+ relation stronger if (i) weak governance, (ii) poor information environment, (iii) low litigation risk, (iv) homogeneous industries.

Comments on Findings

Questions:

- Comparison to Gopalan et al (2014):

  (OLS): Earnings management = function[pay duration, controls]

  How is the control problem that motivates "withholding or delay of bad news" similar/different than "earnings management?"

- **The "average" probability of issuing a "bad news" management forecast in a given year is reported at 35%.**
  - If 35% is "low" - what is the benchmark?
  - Benchmark – Is it the average probability of issuing a "good news" forecast?
  - How does a marginal increase in the probability of issuing a "bad news" forecast of 9.7% (as pay duration increases from Q1 of 0.83 to Q3 of 2.07) translate to a comparison with the assumed benchmark?

Comments - continued

- **Bad news – good news asymmetry**

Accounting research typically compares absolute magnitude of market price reaction (CAR) to good news forecasts to the market reaction to bad news forecasts – where a larger bad news reaction is cited as evidence of delay (Kothari 2009).

Question: Why not test the influence of pay duration based on the conventional design of asymmetric price reaction?

$$\text{CAR} = \alpha + \beta_0 \textit{BadNews} + \beta_1 \textit{PayDuration} + \ldots$$

See Baginsky et al (TAR 2018)

$$\text{CAR} = \alpha + \beta_0 \textit{BadNews} + \beta_1 \textit{SeverancePay} + \ldots$$

Summary remarks

- Well executed, interesting paper that links CEO compensation to voluntary disclosures (management forecasts).
- Best viewed as an extension of Gopalan et al (2014); need to better distinguish current paper.
- Handcuffs (longer pay duration) or parachutes (severance pay)? – equivalent or address different control problems?
- (Un)conventional design.

THANK YOU!