Managers’ Pay Duration and Voluntary Disclosures

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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 are more likely 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”

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

Managerial decisions

Consequences

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,...

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

First stage:

Document the **determinants** of pay duration

- **OLS regression:**
  
  \[
  \text{Pay Duration} = \text{function [firm, CEO, governance, ...]}
  \]

- Well done; wide variety of proxies, robustness tests, ...


- **One (measurement) Question?**
  
  Pay duration vs Vesting period vs Performance period?
Cheng et al. paper

Second stage:

- Document the consequences of pay duration
  - Hypothesis: Firms with longer CEO pay duration are more likely 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.
Questions:

- Comparison to Gopalan et al (2014):
  
  \[(OLS): \text{Earnings management} = \text{function[pay duration, controls]}\]

  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?
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?

\[ \text{CAR} = \alpha + \beta_0 \text{BadNews} + \beta_1 \text{PayDuration} + \ldots \]

See Baginsky et al (TAR 2018)

\[ \text{CAR} = \alpha + \beta_0 \text{BadNews} + \beta_1 \text{SeverancePay} + \ldots \]
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!