The Effect of CEO Friendship and Compensation Saliency on Earnings Management: The Mediating Role of Social Distance

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Structured Abstract:

**Purpose** – The purpose of this study is to examine the possibility of adverse consequences regarding the recently enacted Dodd-Frank Act (DFA) pay-equity disclosure requirement in the U.S. which will likely lead to lower levels of perceived Chief Executive Officer (CEO) pay fairness by subordinates. Specifically, the study examines whether the pay-equity disclosure leads to increased earnings management when business-unit managers have friendship ties with the CEO.

**Design/methodology/approach** – An experiment is conducted wherein participants assume the role of a business-unit manager and are asked to provide an estimate for future warranty expense, which is used as a proxy for earnings management. The study manipulates friendship between the CEO and a business-unit manager and the saliency of CEO compensation pay-equity.

**Findings** – CEO friendship ties, which are associated with lower levels of social distance, result in less earning management in the absence of the DFA CEO pay-equity ratio disclosure. However, CEO friendship may result in negative repercussions in terms of higher earnings management in the post-DFA environment when managers are provided with the pay-equity disclosure.

**Research implications** – Future research may expand this study by examining how the adverse consequences of the CEO compensation saliency disclosure can be mitigated.

**Practical implications** – Management, audit committees and internal auditors should consider the possibility of unintended consequences of the increased transparency of CEO pay-equity while designing management control systems.

**Social implications** – This study highlights the importance of understanding how employees’ social relationships with leaders may influence their behavior.

**Originality/value** – Unlike prior research which focuses on senior executives’ direct incentives to manipulate earnings and subsequently increase their compensation, this study provides evidence regarding the earnings management behavior of business-unit managers.

**Keywords**: social distance, social comparison, earnings management, pay dispersion, Dodd-Frank Act

**Article Classification**: Research paper