Summary of Paper: CEO Pay Cuts and Investors' Perceptions of Earnings Quality

What is this Study About?

The study explores whether CEO pay cuts impact how investors perceive the quality of a company's earnings, using earnings response coefficients (ERCs) as a proxy. It questions whether pay cuts, intended to motivate CEOs, actually reduce the credibility of earnings information.

What are the major findings of the study?

Findings show a 4.6% drop in ERCs following CEO pay cuts, implying reduced investor trust in earnings. The effect is stronger in firms with high accruals or fast-growing earnings—conditions prone to earnings manipulation. However, strong oversight (e.g., specialist auditors, institutional ownership) can mitigate this decline. There is weak evidence suggesting that credit rating agencies may reduce their reliance on earnings after such pay cuts.

Why is the study important?

CEO pay cuts—intended to incentivize performance—may inadvertently trigger investor skepticism. For accountants, auditors, and analysts, this affects earnings reliability, valuation, and audit risk assessments. Importantly, the perceived quality of earnings—not just the actual numbers—can shift investor behavior.

What is the impact on professional practice and society at large?

Reduced earnings credibility can lead to higher financing costs, lower firm valuations, and weaker credit ratings. Boards, auditors, and audit committees should implement complementary monitoring practices or additional disclosures when cutting CEO pay to preserve investor confidence and protect market integrity.

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