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

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ABSTRACT: Recent regulation and initiatives by the Securities and Exchange Commission (SEC) have increased senior executives’ accountability for the faithful representation of their firms’ financial reports. The aggregated nature of large firms requires senior executives to rely on data from lower level managers during the financial reporting process. This data may be subject to bias given managers’ incentives to improve their units’ performance (i.e., earnings management). We conduct an experiment to examine the effects of friendship ties with a chief executive officer (CEO) and saliency of CEO compensation on earnings management by managers through perceived social distance. While social ties with the CEO may decrease earnings management, the recently enacted compensation disclosure requirement under the Dodd-Frank Act may counteract the benefits of these social ties due to increased awareness of CEO pay disparity by managers. Consistent with our predictions, we find that CEO compensation saliency moderates the effect CEO friendship on managers’ perceived social distance such that an association with the CEO decreases perceived social distance when CEO compensation is non-salient relative to salient. Further, we find support for a mediated moderation model in which friendship with a CEO leads to decreased earnings management through a lower level of perceived social distance when CEO compensation is non-salient.