ilLUminate Blog Transcript: **Bright Asante-Appiah on How Fair Pay Affects Firm Value**

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ANNOUNCER: 00:02	[music] This podcast is brought to you by ilLUminate, the Lehigh Business Blog. To learn more, please visit us at business.lehigh.edu/news.
JACK CROFT: 00:14	Welcome. I'm Jack Croft, host of the ilLUminate podcast for Lehigh University's College of Business. Today is November 29th, 2023, and we're talking with Bright Asante-Appiah about his research regarding the relationship between fair pay for employees and a company's long-term value. Dr. Asante-Appiah is an assistant professor of accounting at Lehigh's College of Business. His research delves into how corporate governance mechanisms affect financial reporting and audit quality, firm value, ESG (environmental, social, and governance) risks and opportunities, and managerial myopia. Welcome to the ilLUminate podcast, Bright.
BRIGHT ASANTE-APPIAH: 00:59	Thank you, Jack, for having me.
CROFT: 01:02	Now, for the past half century in America, really, since the 1970s, we've seen sustained economic growth, but pretty much stagnant hourly wages in real terms. So what are some of the main contributing factors that have been identified for that?
ASANTE-APPIAH: 01:21	There has been debate about this issue, as you mentioned, and many people have attributed this issue to many things. Some of them may be the declining union membership in America. Others talk about automation, outsourcing, globalization. But what strikes me is one thing that a business writer once noted in the Forbes magazine, the name [Josh] Bersin-- and that was in 2018. And he noted that this issue is not economic issue. It's a management issue, which is very, very important to bring out, right? So he notes that this stagnant wage is not an economic issue. It is fair management issue.
ASANTE-APPIAH: 02:12	So when you look at the literature, you see that there is this discussion about management relentless efforts to pursue shareholder value, right, at the expense of all other components that a firm should care about. And managers do not do this in isolation. Shareholders care about returning value to them. And anything that hurts firm value becomes an issue. So we've seen evidence of stock prices go up or down when wages go down or up. So CEOs that are focused on the short term have incentive to pursue something that increases profit in the short term. And one of those things is to minimize employee wage. So this has led to wage stagnation and pay to productivity divergence here in the United States. So it appears that employee costs and firm value are considered mutually exclusive. And so we can blame automation and all these things. But then the central focus should be about firm management and their effort to provide shareholder returns and to focus on short-term profits.
CROFT: 03:33	A lot of the debate, particularly in recent years, has centered around employee wage stagnation in comparison to CEO pay and the so-called inequality gap between what the average worker makes and what CEOs are making. And there's been, I believe-- as you mentioned in your study, there's been considerable research around that question. And your recent study with Professor Tamara Lambert looked at the issue of

employee pay fairness from a very different angle. And it was, as you mentioned, how it affects a company's long-term value. So what was it that led you to examine that particular aspect of pay fairness?

ASANTE-APPIAH: 04:21 Oh, thank you, Jack. I think I'm going to try to be brief, but then it's a very, very long background, but I'll try to be brief about this. And the reason is we looked at this because weight fairness and ESG issues continue to dominate media and boardroom discussions. If you look at the reasons why it has become a boardroom issue, we've seen advocacy from ESG investors in particular in this area. And why is it a challenge to corporate managers and board of directors? Well, as I alluded to before, paying non-executive employees more and meeting or exceeding Wall Street profit expectations, I call it a strange little dance, right?

ASANTE-APPIAH: 05:09 And the reason is that high employee costs negatively affect current period profits and can have negative stock market outcomes. Now, let's go back to the research that you talked about. As you mentioned, previous studies have looked at this issue. But the empirical evidence on relation between pay fairness and firm value based on U.S. data, either the researchers fail to detect the predicted relationships or that the findings are contradictory to each other, right, what we call it misfindings. As we look at the literature, what we see is that the studies use proxies of fairness that is based on what we call parity-based justice theory. And what this theory proposes is that it's kind of thinking about equal sharing in outcomes, right? So that is parity-based justice, equal sharing in outcomes. So the measure of pay fairness that has been used in the prior studies, they typically look at something like ratio of average worker pay to CEO pay. So how closeness is this average worker pay to CEO pay? That is the definition of pay fairness that has been looked at in the prior literature. And they try to look at this ratio and how it relates to firm value.

ASANTE-APPIAH: 06:36 But there are two issues if you look at it from that angle. The first one is that parity-based justice theories itself offer bidirectional predictions. And so the misfindings is not surprising, right? But the second most important issue is, Jack, do average employees compare their pay to that of a CEO in order to feel a sense of justice and affect their effort to perform? I think no. And survey evidence backs this. There was a survey by Payscale in 2016, and they find that more than half of employees in the U.S. don't know what their CEO makes. And 79% of those who know don't care. So the question here is, "If people don't know or they don't care if they know, how will this affect even their effort to perform?" If I don't care how much my CEO makes or I don't know how much my CEO makes, how is that going to affect my sense of fairness and my effort to perform and let alone to affect firm value? So we think that this kind of way of measuring fairness has maybe led to the failure to detect predicted relationship in this kind of study. And so looking at the ongoing debate and looking at this boardroom discussion about pay fairness, we think that previous studies have not really looked at this in a way that can associate pay fairness to firm value. And that is why my co-author and I decided to look at this again.

CROFT: 08:24 One question I have before, and then we'll get into some of the details on the study. But you had actually worked for more than a decade in public and corporate accounting roles before moving to academia in 2012. And I wonder how your prior experiences in accounting, what's often called the real world, although I think for students and faculty and a lot of other people, the academia is also a real world. But how did your experience in working with accounting firms influence your research interests now?

ASANTE-APPIAH: 09:08 I would say probably a lot or maybe it is the source. And that experience we talked about, it includes a "Big Four" accounting firm and then later on with a Fortune 100 company in the SEC reporting, accounting policy development, and a whole lot of things. And this got me exposed to senior management and the sort of issues that senior management deals with on a daily basis, right? So when I started my doctoral program, one of the things that I motivated myself was that my research will be motivated by practice issues of the day and then using empirical methods to address them. And during my doctoral studies, one of the things that became apparent to me-- and there was a paper published in this issue as well, published by Dr. Dana Hermanson [of Kennesaw State University] in 2015. It is about the current state of accounting research. The whole thing is that there has been a concern about stagnation in accounting research. One particular author notes that accounting research has become insufficiently innovative and increasingly detached from the practice of the craft. And this was [Anthony G.] Hopwood [of University of Oxford] in 2007. Then another researcher noted that almost none of the papers published in the Accounting Review—and for listeners, Accounting Review is maybe the number one academic journal in the field of accounting.

ASANTE-APPIAH: 10:42 So this publisher noted that almost none of the papers published in this number one accounting journal actually addresses the top 10 accounting challenges that is noted by the American Institute of Certified Public Accountants, the AICPA. So these views and the model that Professor Hermanson suggested in his article is the source of my approach to research. But why are we deviating from the craft of accounting? Why is our research not informing practice? Why is our research not addressing practice issues of the day? So I determined that my research will be based on accounting issues of the day that are discussed by the profession and then using empirical methods to address those issues.

CROFT: 11:39 Now, as I mentioned in the introduction, one of the main areas of focus of your research is ESG or that broad umbrella of environmental, social, and corporate governance. And I wonder then, from your perspective, how does this question of employee pay fairness fit within the context of ESG?

ASANTE-APPIAH: 12:05 Yeah, Jack, as you mentioned, ESG is about environmental, social, and governance issues, right? And anytime we have mentioned ESG, many people immediately talk about environmental issues. And that is understandable. That was their focus maybe a decade ago when this issue became predominant here in the U.S. The reason why pay fairness fits into this is the "S" component-- and before I talk about the "S" component of the ESG, there is this poll conducted by IBD/TIPP. They conducted this poll. And they asked investors questions. They asked, "What is most important when investing in a stock? Return on investment or one of these ESG traits?" Obviously, Jack, as you expect, return on investment will be higher, right? But I've seen that, yes, return on investment probably ranges from 61 to 68 percent of the respondents when they say what is most important. But when it comes to the ESG traits, it's very, very interesting. And this poll was in 2020. We see a shift from environmental issues to social issues to things such as fair employee wages, right, to things such as workforce, management, diversity, and all those things. Yes, environmental commitment is still an issue for ESG investors and the rest, but we are seeing that increasingly they are also concerned about the social component. And the most important thing they are concerned about the social component is fair employee wages. So pay fairness, I believe, is the key to achieving the “S” component of ESG.

CROFT: 14:04 Now, for the study, you had relied on what's known as the efficiency wage theory. Could you explain that to our listeners what that theory entails and what advantages it offers in looking at this issue of pay fairness?

ASANTE-APPIAH: 14:22 So efficiency wage theory suggests higher firm value will result from equity-based measures of pay fairness. And what it predicts is that higher employee pay can induce higher productivity. And findings from several streams of research also support this view. So my co-author and I thought about this mixed findings about pay fairness and firm value. And we thought, "Hmm, instead of using these parity-based measures, comparing average employee pay to, say, CEO pay that has been used in the prior studies, we think it will make sense to really measure pay fairness based on equity-based justice, which is grounded in this efficiency wage theory." Equity-based fairness involves attempting to arrange events so that each person's outcome are proportional to his or her inputs, right? So the benefit of measuring pay fairness based on this approach is that pay-to-productivity relationship will be directly tied to employee effort to perform. And we know that effort to perform is what affects firm value.

CROFT: 15:39 Now, as you started looking at this question of pay fairness, what were some of the main reasons that firms do not pay their employees more fairly?

ASANTE-APPIAH: 15:53 Typically, as I said earlier on, I think-- and if I want to maybe explain this more. I believe it is likely the result of managers viewing human capital as an accounting expense to minimize in the short term without recognizing it as an investment in the firm's value or future value, right? So managers are typically averse to investing in long-term equity building. And the reason is that this may likely be mispriced by shareholders. Shareholders may misinterpret this and may not award or reward managers for that in the short term. So we believe this is potentially the reasons why managers do not pay their employees more fairly.

CROFT: 16:42 And that gets us into something you've talked about. I was wondering if you could explain the role of what's known as managerial short-termism in determining fair pay, starting with defining what managerial short-termism is and how that connects to not paying employees as fairly as perhaps companies should.

ASANTE-APPIAH: 17:07 The simple way of explaining this managerial short-termism is when corporate managers sacrifice long-term value creation in exchange for short-term gains. That is what we in academia call it managerial short-termism. So CEOs who are focused on the short-term have incentive, as I said before, to minimize employee pay. And this leads to this wage stagnation issue that we are talking about. What we did in this study, we look at several proxies of managerial short-termism or corporate environments that breeds managerial short-termism. And for each of these proxies that we used, we found an association between managerial short-termism and less fair pay. In other words, when a firm's environment breeds or provides managers the incentive to engage in short-term profit maximization as opposed to long-term value creation, such firms are more likely to pay their employees less based on the measure that we developed.

CROFT: 18:20 And I'm wondering. One of the things your study addresses is CEO contracts and the way that they're structured and the role that that plays in both fair pay for employees and a firm's long-term value. So if you could explain what the issue is with the way that many CEO contracts are currently structured that leads to less fair pay for employees.

ASANTE-APPIAH: 18:50 So based on the findings from the previous question that you asked about this short-termism, based on the findings that came from the study, we were concerned that, "Oh, so this is the issue. This is the reason that CEOs are reluctant to pay the employees fairly." Is there a corporate governance tool that the board of directors can use to incentivize CEOs to pay their employees more fairly? And we came about this CEO contracting. And just a little bit background. In U.S., the board of directors decide whether the terms of the CEO's employment-- and when I say the terms of the CEO employment, I'm talking about things such as the duration of the employment and renewal options, authority and responsibilities, the CEO compensation and benefits, things such as restrictions on CEO outside activities, and so many things. The board of directors determine whether these things are governed by an explicit agreement. And, Jack, it will interest you to note that most CEOs of American companies, including the most notable ones, they are employed at the will of the board of directors. They do not have explicit employment contracts. That means that they can be sacked at any time, right? So theory suggests that such explicit CEO contracting can motivate CEOs to pursue long-term, value-adding investments, such as human capital, because explicit agreements offer protection from-- assuming there was a fallout from short-term performance, right? If you're a CEO with protection from explicit employment agreement, then you are not so concerned that you're going to be fired just because you failed to meet the short-term performance target.

ASANTE-APPIAH: 20:50 So what we find interestingly is that we see a positive association between explicit CEO contracting and the equity-based measure of pay fairness that we developed. That means that firms that provide contract and explicit contracting to their CEOs are more likely to pay their employees more fairly. And another interesting thing that we noted is that this explicit CEO contracting and pay fairness interact positively on long-term firm value. That means that if you have a firm that provides a CEO with explicit contracting and pays its employees fairly, such firms are more likely to create value in the long term. So we believe that this is very, very important finding that the board of directors have a tool to motivate CEOs to pay their employees more fairly. And as we said, paying employees more fairly and as we find in the study is associated with long-term fair value. So it's a win-win situation for the board. It's a win situation for the CEO, and it's a win situation for the employees.

CROFT: 22:11 What about the shareholders?

ASANTE-APPIAH: 22:14 As I said, if paying employees more is associated-- not paying more. We are not advocating for more pay. We are advocating for fair pay. So if paying employees more fairly is associated with firm value, then that is a win for shareholders. The value belongs to shareholders, right?

CROFT: 22:36 But as in both the CEO's case and the shareholder's case, the way that a lot of companies are run these days, that short term is kind of an oppressive deadline they face each year. And if they report not making as much as was expected or forecast, there can be consequences, as you've mentioned, to that. And the idea that, "Well, we're investing so that in five years, the company will be even more valuable." There are some people who are resistant to that argument, let's just say.

ASANTE-APPIAH: 23:18 Yeah. And, Jack, and that is the issue that we face, right? I mean, should we sacrifice the long term for the short term, or we should pursue policies that is good for us in the long term and in the short term as well, right? So that is the threshold where we come to that. So we are not talking about-- we are not saying that they should forget about the short term. We are talking about policies that sacrifice long-term gains for short-term benefits.

CROFT: 23:51 Okay. And what are the main takeaways then from your study for the board of directors, the companies? What kind of changes should they be making to their own internal organization or processes? And are there any implications for policymakers from what you found?

ASANTE-APPIAH: 24:14 Thank you, Jack. I'm happy to discuss that. So from what we have discussed so far, first of all, let me talk about the implications for companies, right? So our findings should be useful for board of directors interested in ways to motivate CEOs to pay employees more fairly while increasing long-term firm value. So what we note is that our evidence, one of the things that we see is that pay fairness is conditioning on factors that breeds managerial short-termism. And these are things that are within the control of the board of directors. So as I said, it is the duty of the board to determine whether the CEO contractual relationship with the firm is governed by explicit contracting. And our evidence suggests that if the board gives the CEO explicit contracting, such CEOs are more likely to pay the employees more fairly, and that leads to long-term value creation. So we believe that our research findings have implication for board of directors. Second, our findings should be useful to investor groups, labor unions, activists, and other stakeholders interested in convincing boards and firm management that there are economic firm value benefits of pay fairness. So we offer evidence consistent with the view that fair wages have investment-like features not fully captured by the accounting treatment.

ASANTE-APPIAH: 25:48 So currently, employee costs are treated as an expense, right, in the accounting field. But what we are seeing is that from this study, it has investment-like features that affect future firm value. Now, in terms of policy, one of the things that I can think about is there is ongoing project by the Financial Accounting Standards Board or the FASB. And what they are currently doing is that they are currently considering requiring more detailed disclosure about employee compensation. And the reason they're doing that is they say that this may potentially increase transparency around pay fairness. So how our study comes in is, our primary sample represents firms that voluntarily disclose information about employee pay. Currently, such disclosure is not mandated in the U.S. So we believe that we offer a useful or initial scoping evidence that when the FASB makes the requirement for firms to disclose information about their employee compensation, that will be very useful for research and will be very useful for investors because there was future investment like features in employee pay. So these findings are very, very important for policymakers as well in that perspective.

CROFT: 27:18 I'd like to once again thank Bright Asante-Appiah for being with us on ilLUminate today. Bright is a licensed certified public accountant, a certified fraud examiner, and a chartered global management accountant. His research has been published in the Contemporary Accounting Research, Journal of Accounting and Public Policy, and the

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