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Earnings management around employee stock option reissues ☆

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Abstract

We investigate market behavior in a setting where managerial incentives to manipulate earnings and market price should be apparent ex ante to market participants. We find evidence of abnormally low discretionary accruals in the period following announcements of cancellations of executive stock options up to the time the options are reissued. Nevertheless, analysts and investors are not misled. Discretionary accruals have little power in explaining stock price performance during this period. Moreover, discretionary accruals do not explain subsequent analyst forecast errors. Thus, our findings suggest that, in this transparent setting, analysts and investors do not respond to earnings management.

JEL classification: G14; G30; J33; M43

Keywords: Capital markets; Stock options; Earnings management; Discretionary accruals; Executive compensation

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1. Introduction and motivation

The extent to which earnings management by firms affects investor perceptions continues to attract interest. Academic research focuses largely on accounting adjustments to the firm's cash flows from operations. Since the timing of cash transactions does not necessarily match the timing of economic transactions, financial reporting regulations allow firms discretion over accruals.[1] The intention of standard setters and regulators in allowing some degree of reporting flexibility is to provide enough latitude so that financial statements can be made more informative. Nevertheless, in a world of asymmetric information and agency problems, the discretionary nature of accrual accounting can lead to earnings manipulation. As Healy and Wahlen (1999, p. 368) suggests, "… managers (may) use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."

Although there is some evidence that accruals management yields more informative financial statements,[2] there also is strong evidence that investors do not necessarily understand precisely what is communicated by accruals. Sloan (1996) finds that future abnormal stock returns are negative (positive) for firms whose earnings include positive (negative) current accruals. Collins and Hribar (2000), using quarterly earnings data, reports similar evidence that the market overprices accruals. Xie (2001) uses a modification of the Jones (1991) model to estimate normal (benchmark) accruals and finds that Sloan's results are due primarily to the "abnormal" or "discretionary" component of accruals. Such overpricing could reflect an inability of the market to recognize the mean reversion in earnings due to the accruals component.

While evidence of mispricing raises concerns about the usefulness of discretionary accrual accounting, it does not necessarily imply opportunistic manipulation by managers. To get at this issue, a number of studies have focused on firm-specific events that potentially provide strong incentives for management to manipulate market price by managing accruals. There is considerable evidence that manipulation occurs around such events[3] and growing evidence that the market does not see through this type of manipulation. Of particular interest is recent results in Teoh et al. (1998a, b) and Rangan (1998) which suggest that managers aggressively manage accruals prior to initial public offerings and seasoned equity offerings, that the market overprices these accruals, and, thus, that the market overvalues the new issues. A follow-up study by Teoh and Wong

[1]Standard examples of potential discretion include situations in which managers estimate lives and salvage values of long-term assets, pension benefit obligations, losses from bad debts, asset impairment, and deferred taxes. Moreover, managers choose among different methods for reporting depreciation and inventory, for managing working capital, and for structuring corporate transactions such as a business combination. See the Healy and Wahlen (1999) survey article for a more complete discussion.

[2]For example, Dechow (1994) finds that current earnings are better than current cash flows in predicting future cash flows and Subramanyam (1996) finds that discretionary accruals are value-relevant.

[3]Healy (1985) documents earnings manipulation in connection with managerial bonus compensation. There is strong evidence of earnings management by banks of loan loss provisions (Beaver et al. (1989), Moyer (1990), Scholes et al. (1990), and successors) and by insurers of property and casualty claim loss reserves (among others, see Petroni (1992), Beaver and McNichols (1998)). Perry and Williams (1994) finds that unexpected accruals are income-decreasing (negative) prior to an MBO. There is also evidence that managers tend to report positive discretionary accruals prior to stock-financed acquisitions (Erickson and Wang, 1999).