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The impact of accounting restatements on CFO turnover and bonus compensation: Does securities litigation matter?

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ABSTRACT

This paper examines the association between accounting restatements, class-action securities litigation and chief financial officer (CFO) turnover and bonus compensation. We identify income-decreasing earnings restatements that were the result of aggressive accounting policies, and hypothesize that these restatements will result in higher CFO turnover rates, and lower bonus compensation, especially when the firm is the target of a restatement-related class-action securities lawsuit. Our results indicate that CFO turnover and bonus compensation are affected by restatements, but only when the restatement firm is the target of a class-action suit. When we expand the analyses to consider other types of executives (e.g., CEOs and COOs), we continue to find that turnover only occurs in the presence of a class-action suit. However, bonus compensation penalties to other types of executives are not limited to litigation-related restatements.

1. Introduction and synopsis

This paper examines the association between accounting restatements, class-action securities litigation and chief financial officer (CFO) turnover and bonus compensation. Prior research has documented mixed evidence that top executives (e.g., chief executive officer, president, chairman of the board) of firms restating earnings are terminated because of the restatement event. Some published (or forthcoming) studies find that non-GAAP (i.e., not in accordance with generally accepted accounting principles) financial reporting is associated with increased top executive turnover (e.g., Arthaud-Day, Certo, Dalton, and Dalton, 2006; Desai, Hogan, and Wilkins, 2006; Collins, Masli, Reitenga, and Sanchez, in press), while other published work finds little evidence of increased turnover (Agrawal, Jaffe, and Karpoff, 1999; Beneish, 1999; Persons, 2006). Further, there is little published research on whether less severe punishments, such as reductions in compensation, are levied against top executives of restating firms. Arthaud-Day et al. (2006) and Wahlen (2004) point out that restatements of earnings that were previously overstated present researchers an interesting laboratory for examining the linkage between managerial competence/integrity/legitimacy and disciplinary actions, because the degree of the misstatement can be observed *ex post*.

Public confidence in the ethical standards of business executives remains very low, and it is likely that confidence in firms taking disciplinary actions against managers engaging in fraudulent reporting is likely very low as well.[4] Media coverage of corporate fraud and restatements from the late 1990s to date has been extensive, and a consensus seems to have developed in the popular press that executives go unpunished for earnings manipulations and even outright fraud (see, e.g., Lublin and Forelle, 2004).[5] This perception has given rise to both recent legislation and litigation designed to

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[4] As of November 2005, Gallup News Service reports that only 16% of respondents rated "the honest and ethical standards" of forbes executives as very high or high (Jones, 2005).

[5] For instance, an analysis carried out by USA TODAY suggested that some (but certainly not all) executives linked to five of the 10 largest earnings restatements in the US history (e.g., WorldCom, Rite Aid, Xerox, Cendant, Conseco, National Commerce Financial) have retained their jobs or they hold high-ranking positions with other important companies (Krantz, 2002). Of course, recent events have suggested that the criminal justice system is successfully prosecuting a number of these managers (see, e.g., Lublin and Rhoads, 2005), even when the managers claim to have been unaware of the financial improprieties at their firms. Thus, with the convictions and guilty pleas mounting, these perceptions of little or no punishment are likely to change over time.

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force managers to disgorge bonuses and other compensation that are tied to manipulated earnings.[6] Such public perceptions, combined with the inability of prior research to establish a consensus on disciplinary actions, suggest that more research in this area is needed.

A careful review of the existing literature identifies two areas that warrant further investigation. First, research into the restatement-related turnover and compensation penalties levied against CEOs and CFOs is relatively limited. Second, there is little research examining the influence of class-action lawsuits on penalties imposed on executives following earnings restatements.[7] Yet the ability of shareholders to bring such securities litigation is an essential component of corporate governance (Shleifer and Vishny, 1997). Absent stronger corporate governance, class-action litigation may be a mechanism that is effective in removing or levying punishment against incumbent management implicated in accounting restatements.

Our research focuses on these two primary issues. First, following the call for research by Arthaud-Day et al. (2006), we extend the extant research to focus on both management turnover and bonus penalties, with our primary focus on the CFO of the firm. While termination is clearly a severe punishment for accounting misstatements resulting in restatement, other less severe penalties, such as cuts in bonus pay, can be imposed. We focus on the CFO due to her or his primary responsibility for the financial reporting process (Mian, 2001; Geiger and North, 2006), whereas, with the exception of Arthaud-Day et al. (2006) and Collins et al. (in press), most of the published research has focused on the CEO, president and chairman (e.g., Desai et al., 2006).[8] In its passage of the Sarbanes–Oxley Act of 2002, the United States Congress saw fit to require CEOs and CFOs to personally certify the accuracy and completeness of the external financial reports of their respective firms (Geiger and Taylor, 2003). As such, under the law, the CEO and CFO are expected to share personal legal responsibility and to suffer similar consequences for fraudulent financial reporting. Implicit in this legal requirement is the notion that the CFO is in a position to influence significantly the financial results reported by the firm to investors and regulatory authorities (Geiger and North 2006). Finally, there is a pressing need for research into the impact of securities litigation as a means of imposing disciplinary action on firms engaging in aggressive financial reporting. While restatements are accompanied by an increased likelihood of securities litigation (Palmrose and Scholz, 2004), there is relatively little evidence suggesting that this external enforcement mechanism acts to impose discipline on managers when other governance mechanisms might fail, and little research examining the impact of class-action litigation in the restatement context.

We contribute to the literature in this area in three significant ways. First, similar to Arthaud-Day et al. (2006), we extend research into restatement-related turnover for executives that are not at the highest level of the firm (i.e., officers other than CEO, president or chairman). The current round of scandals involving overstated earnings has implicated CFOs as well as CEOs.[9] Given the shared responsibility of the CEO and CFO for financial reporting, it is important to understand the disciplinary actions taken against CFOs as well as CEOs. Second, we examine bonus compensation penalties to CFOs (and other executives) resulting from earnings restatements. This issue has not been addressed in the prior published literature, yet evidence on this issue relates directly to the debate accompanying Section 304 of the Sarbanes–Oxley Act. Third, we consider the influence of class-action lawsuits on the punishments imposed on CFOs. Prior research finds that restatements frequently trigger class-action and other lawsuits (Palmrose and Scholz, 2004), while other research suggests that lawsuits may be associated with lower executive compensation (Persons, 2006) and higher executive turnover (Strahan, 1998; Niehaus and Roth, 1999). Our research empirically links these two streams of research as they relate to the restatement context and directly tests the associations between disciplinary actions, accounting restatements and class-action securities litigation.

The starting point for our sample of restatement firms is the General Accounting Office (GAO) report dated January 17, 2003 (GAO-03-395R), which identifies firms that restated earnings between January 1, 1997 and June 30, 2002. We then add post-GAO report restatement firms identified by Baber, Kang, and Liang (2006) for the years 2003–2004. After reducing the original sample for various reasons (e.g., firms not in ExecuComp, restatements not the result of aggressive accounting leading to earnings overstatement, CFO data not disclosed, etc.), our final sample consists of 81 firms that overstated their earnings at least once in the period from 1997 to 2003, along with 81 control firms matched on the basis of industry, size and CFO data availability.

Consistent with our predictions, we find that, in restatement years, CFO turnover rates are higher in the restatement firms relative to our control firms, and that CFO bonus compensation is lower in the restatement firms. However, our evidence suggests that CFOs are only penalized when the earnings restatement triggers a class-action lawsuit. Since it is possible that litigation only occurs when restatements are severe in nature, we re-estimate our models after including variables for the restatement amount scaled by assets, the litigation settlement amount, the issuance of an Accounting and Auditing Enforcement Release (AAER) and the market reaction to the restatement. We find that litigation — not common measures of restatement severity — is the determining factor in CFO penalties. This suggests that there is increased public pressure on the board to take action when the restatement is associated with a class-action suit (Palmrose and Scholz, 2004). Whatever the mechanism by which the litigation triggers disciplinary actions, the litigation-related restatement CFO turnover rate of 57% is extreme, even when compared to the CFO turnover rate in a separate sample of firms with extremely poor performance.

When we expand the analyses to the two years before the restatement and the year after the restatement, we find no significant differences in turnover between the restatement firms and the control firms in the pre- and post-restatement period. However, we do find evidence of lower bonus payments to CFOs in the year before the restatement, which could be related to the firm having advance knowledge of the aggressive accounting problem. When we expand

[6] With respect to legislation, Section 304 of the Sarbanes–Oxley Act of 2002 requires that, if a company is required to restate prior period earnings, the CEO and the CFO of the firm are required to reimburse the firm for any bonus or other incentive (equity) based compensation received by that person(s) during the twelve month period following the first public issuance or filing with the SEC (whichever occurs first) of the financial statements containing the overstatement. Section 304 also requires that the CEO and CFO of the company reimburse the company for any profits realized from the sale of securities of the firm during the 12-month period. With respect to litigation, a shareholder of Computer Associates International Inc. (CA) filed suit in late June of 2004 against 10 former and two current CA executives in order to force the executives to repay more than $1 billion in cash, stock options and restricted stock that the shareholder alleges were paid to the executives based on erroneous financial reporting (McDonald, 2005).

[7] An unpublished working paper by Strahan (1998) reports that the likelihood of CEO turnover increases when a firm is subject to class-action litigation. Niehaus and Roth (1999) find that class-action litigation is associated with higher CEO turnover. However, neither paper examines the restatement context and neither focuses on CFOs.

[8] Two concurrent working papers, Burks (2008) and Hennes, Leone and Miller (2007), have also focused on the CFO. Like Arthaud-Day et al. (2006) and Collins et al. (in press), they find evidence of restatement-related penalties levied against incumbent CFOs. However, none of these papers has examined the association between restatement-related class-action securities litigation and the imposition of penalties.

[9] Specifically, the Committee of Sponsoring Organizations of the Treadway Commission noted that, in the instances of fraudulent financial reporting it studied from 1987 to 1997, the CFO was implicated by the SEC in 43% of its Accounting and Auditing Enforcement Releases (AAERs; Beasley, Carcello, and Hermanson, 1999; see also Young, 2006).