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Why do corporate managers misstate financial statements? The role of option compensation and other factors ☆

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Abstract

We investigate the incentives that led to the rash of restated financial statements at the end of the 1990s market bubble. We find that the likelihood of a misstated financial statement increases greatly when the CEO has very sizable holdings of in-the-money stock options. Misstatements are also more likely for firms that are constrained by an interest-coverage debt covenant, that raise new debt or equity capital, or that have a CEO who serves as board chair. Our results indicate that agency costs increased [Jensen, M.C., 2005a, Agency costs of overvalued equity. Financial Management 34, 5–19] as substantially overvalued equity caused managers to take actions to support the stock price.

JEL classifications: M41; M52; J33; G34

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1. Introduction

Did outsized stock option packages coupled with market overvaluation during the late 1990s lead to the rash of accounting misstatements? Motivated by this question, we study the association between accounting restatements and the intrinsic value of the CEO's in-the-money stock option holdings. This measure, which is calculated as the number of options times the excess of the stock price over the exercise price, captures the effects of both large option grants and any equity overvaluation. While managers may have obtained short-term benefits from misstating accounting reports, this action put them at odds with their long-term stockholders and bond holders: Restatement announcements caused market capitalization losses of about $100 billion and substantially reduced public confidence in the business community and capital markets (GAO, 2002).

The structure of executive compensation changed dramatically during the late 1990s as the use of stock options increased. The ratio of average CEO total compensation to average production worker compensation increased almost fourfold in only six years (from 150 in 1994 to 570 in 2000), due almost entirely to a rapid increase in the value of option grants (Hall and Murphy, 2003; Jensen, 2005b) as stocks reached unprecedented levels during the 1990s bull market. When the firm's stock price becomes overvalued (i.e., 100%—or even 1,000%—above underlying firm value), potential conflicts of interest between managers and owners expand (Jensen, 2005a). Jensen argues the core source of the problem is that, except by pure luck, managers cannot produce the performance required to justify the high stock price. Overvalued equity therefore creates a setting in which some managers (agents) take actions to support the firm's short-term stock price, and those actions are costly to the current debt-holders and long-term stockholders (the principals).

Prior research finds that option compensation can provide managers with incentives to act in the best interests of shareholders. Indeed, several studies find that the asymmetric payoff provided by stock options can reduce agency costs by encouraging risk taking by managers of firms with high growth opportunities (Smith and Watts, 1992; Gaver and Gaver, 1993; Baber, Janakiraman, and Kang, 1996). Further, Rajan and Wulf (2003) find that greater stock-based compensation may be justified by the flattening of organization structures over the past 14 years. The issue, therefore, is not whether stock option compensation should be used, but whether the amount of options should be limited when managers already have substantial in-the-money option holdings. In Senate testimony Greenspan (2002) linked recent accounting problems to poorly structured option contracts that "perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising." Similar views were expressed by Warren Buffet in his 1998 letter to shareholders (Buffet, 1998). Despite such statements, the evidence on the relation between option holdings and accounting misstatements is largely anecdotal (e.g., Lowenstein, 2004).

Since we are interested in periods when equity is substantially overvalued, we focus our study on restatements announced in 2001 or 2002. We read company press releases and financial reports to determine the specific years of the misstatements and we measure managers' incentives at that time. As we document below, several measures indicate that equity was overvalued for our sample firms at the time of the misstatement. Using logistic regressions to compare 95 firms that announced a restatement to a control sample matched on industry, size, and time, we find that the most influential factor affecting the likelihood