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Earnings Restatement and Stock Compensation

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Abstract. This study seeks to examine the likelihood of earnings restatement based upon executive compensation for pre and post the Sarbanes Oxley Acts (SOX) of large public companies. By using the data compensation of S&P 500 executes of large public companies, this study expects that earning restatements may be more frequent during post SOX periods simply because these events survive prior to SOX and the restatements occur after SOX.

Keywords: Stock Compensation, Earning restatements, Sarbanes Oxley Acts.

1. Introduction

The increased number of illegal practices of stock option and earning restatements of public companies due to aggressive application of accounting rules can be related to executive compensation in stock option. The Sarbanes Oxley Acts (SOX) require accountants to be sensitive to possibility of material misstatements causing restatements and fraudulent reporting (Wilder, 2004).

This study seeks to examine the likelihood of earnings restatement based upon executive compensation for pre and post SOX of large public companies. Stock options may be a red flag for financial restatements. Managers could manipulate their through accounting choices with little repercussions for pre SOX. Post SOX, there should be less freedom to manipulate stock prices through accounting choices. But these companies are restating their financial statements. In fact, restatements have increased and this may be due to prior period adjustments.

2. Literature Review

2.1. The Sarbanes Oxley Acts

The recent corporate scandals such as Enron, Global Crossing, Tyco, and World.Com have shaken investors' confidence and made it difficult for companies to raise equity from the stock market. Many reports believed that the board and its committees do not supervise management properly. For example, Enron manipulated its financial statements through off balance sheet activities. The board was unable to disclose the distorted statements because the board lacked independence from senior executives. Moreover, World.com materially overstated its earnings and finally filed for bankruptcy under chapter 11. The investigation showed that the audit committee failed to perform the duties (Weiss, 2005).

Consequently, Congress passed the Sarbanes-Oxley Act of 2002 (SOX) to address accounting reform, improve corporate governance, and restore investors' trust. This new law includes provisions such as a majority of independent directors, executive certification of financial statements, financial experts on audit committees, and managerial assessment of internal control (Chhaochharia & Grinstein, 2005).

2.2. Stock Compensations

Several factors such as culture, control and compensation as a form of motivation can have a significant impact on how executives think for long-term and short-term. This can be said for executives according to Kohlberg's stages of cognitive stages moral development. The agency theory states that managers acting as agents in the fiduciary capacity to provide financial returns to the shareholders (Antle, 1989).

Agency theory focuses on the principal-agent relationship. Jensen & Meckling (1976) defines an agency relationship as a contract under which one or more persons engage the agent to perform some service on their behalf which involves delegating some decision making authority to the agent. The principals are the owners of the firms. The agent has daily basis control and functions on behalf of the principals. If both parties to the relationship are to maximize their utilities, there is a good reason to believe that the agent will not always act in the best interests of the principal (Jensen & Meckling, 1976).

The separation of ownership and control along with divergent interests gives rise to agency problems. Agency problems include adverse selection and moral hazard. Adverse selection is the condition under which agents misrepresent or hide information. Moral hazard is the condition under which agents do not put forth the maximum efforts (Eisenhardt, 1989).

Stock based ownership as a form of reward or compensation promotes long term thinking as opposed to stock option based compensation. Stock based compensation induces managers and employees to promote the long-term successful operation of the company. This would eventually reveal in the appreciation of stock price. The unusual level of stock options as a form of compensation to executives, in addition to its financial impact on cash flow and provide a warning to accountants of increased likelihood of earning restatements due to short term thinking of the firm (Brandes and Hadani, 2006).

There are basic fundamental differences between stock ownership and stock options incentives. Investors who own stock tend to invest for the longer term than other forms of investment. When one purchases shares of stock, one expects to receive dividend in the future and to achieve capital gain in form of appreciation of these stock prices. Investors are usually more patient to realize stock price appreciation that may take months since corporations are not obligated to declare and pay dividends. Executives receive stock options at significantly below market rates and could benefit significantly in the short-term if the earning is favorable and result in stock price appreciation. When the executives exercise their stock options at the low prices, they can immediately trade them in the open market for a short-term profit.

Shareholders can lower the fraudulent risks of earning management with controls over incentive packages made available to executives. Hannafey (2003) arguments can be made for corporations to aid in the determination of executive compensation plans, stock options or stock ownership to promote ethical decision-making process.

2.3. Earning Restatements

Financial statement restatements often involve material accounting omissions or misstatements in prior period financial reports. The increases of earning restatements over the last decade raise questions about the quality of accounting reports (Palmrose and Scholz, 2000). For example, Huron (2005) investigated that there are 1,295 restatements.

Eilifsen and Messier (2000) identified four conditions must exist for audited financial statement restatements:(1) a material misstatement occurs as the result of inherent risk such as management's aggressive accounting practices or misapplication of GAAP, (2) the misstatement is neither detected nor prevented by the company's internal controls, (3) the external auditor fails to notice the misstatement and financial statements before they are issued,(4) the misstatement is subsequently discovered and, if material, requires correction, restatement and reissuance of financial statements. The presence of the first three conditions is likely causes of financial statement frauds.

Kinney and McDaniel (1989) inspected 73 companies that file for statements from 1976 to 1985. They found that companies tend to be small in size, less profitable with higher debt and uncertainties.

Defond and Jiambalvo (1991) appraised 41 companies in poor financial conditions that restated their annual reports from 1977 to 1988 and found that there is a relationship between earning errors and managers responding to compensation incentives.

2.4. Stock Compensation and Earning Restatements

Arguments of stock options fall out that executives are motivated to use questionable accounting practices to increase their stock prices. Executives at Quest communications make about $500 million in selling company stock from 1999 to 2001 by using inflated accounting results with fraudulent accruals. The basic good reason behind the stock option condition is the alignment of a manager's system to improve the firm's business and its stock valuation. Both the firm and the stockholders realize a large financial gain when the stock worth goes up.

The stock options for executive compensation are to counter balance the inherently short-term orientation of annual bonuses and salary based compensation. The stock options align the interests of managers and that of outside shareholders to reduce the short-term approach of agency problems. However, option values are sensitive to fluctuations in stock prices and they represent and very significant part of total compensations (Choe, 2006).

Investors' reward firms that meet or exceed earning expectations. Executives have cashed in and earned sizable option components of their earnings. Firms that reward their executives heavily on options, more frequently file for restatements (Bauman&Shaw, 2006).

3. Research Design

This research uses Compustat to search for data ompensation of S&P 500 executes of large public companies. The Compustat database provides data on salary and bonus compensation of these officers plus stock ownership or stock option. The compensation of these executes can be verified in SEC 10-K filings and segregate these data into two periods: pre SOX and Post SOX.

This study uses a two-way ANOVA to test hypotheses on the means of groups.Population means can be tested in two-way ANOVA to see whether the means are equal for all categories of a factor and to see if any of the factors interact with each other (Norusis, 1999).

In ANOVA, the independent variables need to be categorical while the dependent variables need to be continuous (Hanke & Reitsch, 1994). The dependent variables must be obtained from different companies and independent of one another. The variance in the dependent variable should be the same within each category of the independent variable (Hawkins & Weber, 1980). The distributions should be dispersed normally with no significant skews.

4. Conclusions

This study expects that earning restatements may be more frequent during post SOX periods simply because these events exist prior to SOX and the restatements occur after SOX. This also sustains a non monetary indicator of the auditing approach. Companies have short-term thinking due to use of stock options as a reward and executives are more likely to experience earning restatements. This is in contrast to companies that have a long term strategic thinking approach for awarding senior management with stock option ownership instead of stock option incentives.

A limitation could exist where results relationship between stock options and likelihood of restatements may vary significantly from industry to industry.

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