How Powerful CFOs Camouflage and Exploit Equity-Based Incentive Compensation

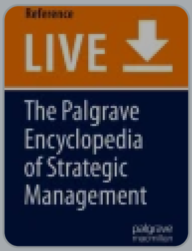
Original Paper | Published: 05 January 2017

Volume 153, pages 591–613, (2018) Cite this article

Journal of Business Ethics

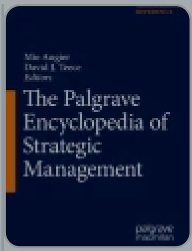
compensation. Second, when their incentive equity compensation vests, we suggest that CFOs manage earnings to further enhance their personal income. Consistent with our theoretical expectations, we find higher levels of income-increasing accrual-based earnings management and real transactions management, a potentially unethical practice, in firms with powerful CFOs who have short pay durations. We discuss the implications of our analysis in the context of mitigating CFO power and managing the ethical environment "tone at the top."

Similar content being viewed by others



CEO Compensation

Chapter | © 2016



CEO Compensation

Chapter | © 2018

How did the Sarbanes–Oxley Act affect managerial incentives? Evidence from corporate acquisitions

Article | Open access

10 December 2021

Notes

(salary and bonus) is available in the contemporaneous year, CFOs must wait, usually between 1 and 5 years, before their grants of restricted stock and stock options vest and they have full rights to the shares. Two CFOs may have the same level of total compensation but one may place a higher value on his/her compensation because he/she has unrestricted access to it sooner. For example, consider two CFOs who both receive total compensation of one million dollars. CFO A receives a $750,000 salary and a $250,000 bonus, so CFO A's pay duration is zero years because he/she receives all of his/her compensation by the end of the fiscal year. CFO B receives a $500,000 salary and $500,000 in stock options that vest in four years, so CFO B's pay duration is two years (we present details on this calculation in "Methods" section below).

4. As an example, see the 2006 disclosure for Michael Herbert, CFO of Simpson

6. Graham et al. (2005, p. 35) identify some of the discretionary transactions managers can choose to undertake or forgo in order to achieve financial reporting objectives. These include (1) decreasing/increasing research and development, advertising, and/or maintenance expenditures, (2) increasing or decreasing inventories, (3) liberalizing credit terms or discounts to encourage customers to purchase more product, and (4) selling investments or assets to recognize gains.

7. “Rents” refer to the excess compensation or the more favorable compensation arrangements that an executive receives over what he/she would have received had his/her compensation contract been obtained in a true arm’s length negotiation (Bebchuk and Fried 2003).

efficiently, the managerial power theory would suggest a departure from efficient contracting toward a negotiation where the executive can wield influence and power to improve the outcome of the negotiation in his/her favor.

10. Gopalan et al. (2014) find that the pay duration of the CEO is inversely related to the level of accruals manipulation. We extend this by looking at earnings management and CFO pay duration.

11. All CFOs with short durations may desire to manage earnings upward, but not all may have the influence to accomplish it. Because of the influence they wield in the firm, powerful CFOs with short duration may be more likely to manage earnings to maximize their compensation.

13. While not using tenure directly, Geiger and North (2006) find that a firm's use of discretionary accruals decreases significantly after the appointment of a new CFO. Presumably, this may be because the new CFO lacks the influence over personnel and the specific firm knowledge that allows CFOs the ability to manage earnings.

14. The calculation as presented assumes restricted stock grants and stock option grants vest on a cliff schedule (all at the end of the vesting period). Similar to Gopalan et al. (2014), if grants vest on a graded schedule (i.e., a portion of the grant vests each year until fully vested), we use $(t_i + 1)/2$ in place of t_i and $(t_j + 1)/2$ in place of t_j.

of pre-2006 stock grants using totals by executive and year only as these grants do not have an exercise price or expiration date. If we are unable to estimate the vesting period for pre-2006 grants or ExecuComp and Equilar disagreed on the number of new grants in any particular year, we drop these observations from our sample.

17. As in Eq. (1), we adjust our calculation for grants that vest on a cliff schedule. See footnote 14.

18. Equilar Inc. is an executive compensation research firm. They collect executive compensation data from firm proxy statements.

19. The ExecuComp database includes data item CFOANN to indicate what

23. We scale the ranks as follows: quartile rank of zero = zero, quartile rank of one = 1/3, quartile rank of two = 2/3, and quartile rank of 3 = 1. We follow a similar procedure for the CFO power index.

24. Kothari et al. (2005) show that researchers can improve the reliability of results in studies involving earnings management by using performance matching to calculate abnormal accruals.

25. We require twenty observations within a two-digit SIC code to perform our analysis.

financial institutions and utility firms and rerun the regressions reported in Table 5, our results remain quantitatively similar (results not tabulated).

References

Abernethy, M. A., Kuang, Y. F., & Qin, B. (2015). The influence of CEO power on compensation contract design. *The Accounting Review, 90*(4), 1265–1306.

Article Google Scholar

Adams, R. B., Almeida, H., & Ferreira, D. (2005). Powerful CEOs and their impact on corporate performance. *The Review of Financial Studies, 18,* 1403–1432.

Google Scholar

Arya, A., Glover, J., & Radhakrishnan, S. (1998). *The controllability principle in responsibility accounting: Another look*. Working Paper, The Ohio State University, Carnegie Mellon University, and New York University.

Badertscher, B. (2011). Overvaluation and the choice of alternative earnings management mechanisms. *The Accounting Review, 86*(5), 1491–1518.

Article Google Scholar

Balsam, S., & Miharjo, S. (2007). The effect of equity compensation on voluntary executive turnover. *Journal of Accounting and Economics*, *43*, 95–119.

Article Google Scholar

Bedard, J. C., Hoitash, R., & Hoitash, U. (2014). Chief financial officers as inside directors. *Contemporary Accounting Research, 31,* 787–817.

Article Google Scholar

Bergstresser, D., & Philippon, T. (2006). CEO incentives and earnings management. *Journal of Financial Economics, 80,* 511–529.

Article Google Scholar

Bigley, G. A., & Wiersema, M. F. (2002). New CEOs and corporate strategic refocusing: How experience as heir apparent influences the use of power.

incentive compensation motivate managerial behaviors? An experimental investigation of the fit between incentive compensation, executive core self-evaluation, and firm performance. *Strategic Management Journal, 33,* 1343–1362.

Article Google Scholar

Cohen, D. A., & Zarowin, P. (2010). Accrual-based and real earnings management activities around seasoned equity offerings. *Journal of Accounting and Economics, 50,* 2–19.

Article Google Scholar

Collins, D. W., Gong, G., & Li, H. (2009). Corporate governance and backdating of executive stock options. *Contemporary Accounting Research, 26,* 403–445.

equity compensation when managers retire, resign, or die. *Journal of Corporate Finance, 14,* 499–511.

Article Google Scholar

Dechow, P. M. (2006). Asymmetric sensitivity of CEO cash compensation to stock returns: A discussion. *Journal of Accounting and Economics, 42,* 193–202.

Article Google Scholar

Dechow, P. M., & Dichev, I. D. (2002). The quality of accruals and earnings: The role of accrual estimation errors. *The Accounting Review, 77,* 35–59.

Article Google Scholar

Finkelstein, S. (1992). Power in top management teams: Dimensions, measurement, and validation. *Academy of Management Journal, 35,* 505–538.

Google Scholar

Fu, X., & Ligon, J. (2010). Exercises of executive stock options on the vesting date. *Financial Management, 39,* 1097–1125.

Article Google Scholar

Geiger, M. A., & North, D. S. (2006). Does hiring a new CFO change things? An investigation of changes in discretionary accruals. *The Accounting Review, 81,* 781–809.

Gunny, K. (2010). The relation between earnings management using real activities manipulation and future performance: Evidence from meeting earnings benchmarks. *Contemporary Accounting Research, 27,* 855–888.

Article Google Scholar

Hall, B. J., & Murphy, K. J. (2002). Stock options for undiversified executives. *Journal of Accounting and Economics, 33,* 3–42.

Article Google Scholar

Healy, P. M. (1985). The effect of bonus schemes on accounting decisions. *Journal of Accounting and Economics, 7,* 85–107.

and restricted stock consistent with economic theory? *Contemporary Accounting Research, 26,* 899–932.

Article Google Scholar

Hribar, P., & Collins, D. W. (2002). Errors in estimating accruals: Implications for empirical research. *Journal of Accounting Research, 40,* 105–134.

Article Google Scholar

Hribar, P., & Nichols, D. C. (2007). The use of unsigned earnings quality measures in tests of earnings management. *Journal of Accounting Research, 45,* 1017–1053.

Article Google Scholar

Johnson, E. N., Fleischman, G. M., Valentine, S., & Walker, K. B. (2012). Managers' ethical evaluations of earnings management and its consequences. *Contemporary Accounting Research, 29,* 910–927.

Article Google Scholar

Jones, T. M. (1991). Ethical decision making by individuals in organizations: An issue-contingent model. *Academy of Management Review, 16,* 366–395.

Article Google Scholar

Joseph, J., Ocasio, W., & McDonnell, M. H. (2014). The structural elaboration of board independence: Executive power, institutional logics, and the adoption of CEO-only board structures in U.S. corporate governance. *Academy of Management Journal, 57,* 1834–1858.

discretionary accrual measures. *Journal of Accounting and Economics, 39,* 163–197.

Article Google Scholar

Lie, E. (2005). On the timing of CEO stock option awards. *Management Science, 51,* 802–812.

Article Google Scholar

Menon, K., & Williams, D. D. (2008). Management turnover following auditor resignations. *Contemporary Accounting Research, 25,* 567–604.

Article Google Scholar

Park, J. H., Kim, C., Chang, Y. K., Lee, D. H., & Sung, Y. D. (in press). CEO hubris and firm performance: Exploring the moderating roles of CEO power and board vigilance. *Journal of Business Ethics*. doi:10.1007/10551-015-2997-2

Peng, L., & Roell, A. (2010). *Managerial incentives and stock price manipulation*. Working paper, CUNY and Columbia University.

Pitesa, M., & Thau, T. (2013). Compliant sinners, obstinate saints: How power and self-focus determine the effectiveness of social influences in ethical decision making. *Academy of Management Journal, 56*(3), 635–658.

Article Google Scholar

Sousa, M., & van Dierendonck, D. (in press). Servant leadership and the effect of the interaction between humility, action, and hierarchical power and follower engagement. *Journal of Business Ethics*. doi:10.1007/s10551-015-2725-y.

Article Google Scholar

Tost, L. P., Gino, F., & Larrick, R. P. (2013). When power makes others speechless: The negative impact of leader power on team performance. *Academy of Management Review, 56,* 1465–1486.

Article Google Scholar

Treviño, L. K. (1986). Ethical decision making in organizations: A person-situation interactionist model. *Academy of Management Review, 11,* 601–617.

announcements. *The Journal of Finance, 52,* 449–476.

Article Google Scholar

Zang, A. Y. (2012). Evidence on the trade-off between real activities manipulation and accrual-based earnings management. *The Accounting Review, 87,* 675–703.

Article Google Scholar

Author information

Authors and Affiliations

Rawls College of Business, Texas Tech University, Lubbock, TX, USA

About this article

Cite this article

Collins, D., Fleischman, G., Kaden, S. *et al.* How Powerful CFOs Camouflage and Exploit Equity-Based Incentive Compensation. *J Bus Ethics* **153**, 591–613 (2018). https://doi.org/10.1007/s10551-016-3427-9

Received	Accepted	Published
16 August 2016	22 December 2016	05 January 2017

Issue Date

December 2018

DOI

https://doi.org/10.1007/s10551-016-3427-9

Keywords

Chief financial officers · Compensation · Pay duration · Incentives