How Powerful CFOs Camouflage and Exploit Equity-Based Incentive Compensation

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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."

obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process).”

3. CFO compensation is typically comprised of a combination of salary, bonuses, restricted stock grants, and stock option grants. While cash compensation (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

compensation strategies that powerful CFOs employ constitute unethical behavior because, although they are not illegal, the strategies would likely be morally unacceptable to the larger community if the actions were publicly known.

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.

9. Under efficient contracting, the duration of the executive's pay package would be determined by firm characteristics and economic factors (Core and Guay 1999). Further, an assumption of efficient contracting is that the board of directors and the executive are negotiating at "arms-length." While we cannot conclusively state that the board and the executive are not negotiating 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.

opportunistic reasons or to reveal private information, the executive would benefit from higher stock prices, if her or his pay duration is short. To sum, even if the CFO engages in earnings management for informational reasons, the impact would be the same: a boost to stock prices, which in turn benefits the manager.

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

number of unvested pre-2006 grants that remain at the end of each year. We are able to track the changes from 2006 through 2009 to estimate the vesting schedules of those pre-2006 grants. For any pre-2006 grants remaining at the end of 2009, we assume these grants vest at the end of the next year. We follow a similar procedure for estimating the vesting schedules 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.

22. Specifically, the CEO power index ranges from zero to three. First, we assign each CEO a one if she or he serves as chairman of the board of directors. Second, we assign each CEO a one if her or his tenure as CEO of the firm is greater than the median CEO tenure. Finally, we assign each CEO a one if he or she holds more titles than the median CEO titles held.

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.

similar results to the Badertscher's (2011) measure for total RTM (results not tabulated).

28. Consistent with other papers that study earnings management, we eliminate financial institutions and utility firms from our analysis. If we include financial institutions and utility firms and rerun the regressions reported in Table 5, our results remain quantitatively similar (results not tabulated).

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Table 7 Variable definitions

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