



Discussion of: Rank and file employees and the discovery of misreporting: The role of stock options



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ABSTRACT

Call, Kedia and Rajgopal (2016) provide intriguing evidence concerning the apparent role of employee stock options in inducing rank and file employees to be complicit in corporate misconduct. They conclude that granting options to rank and file employees provides incentives for them to facilitate misreporting and discourages them from whistleblowing. In this discussion, I argue that the evidence is largely circumstantial and puzzling in several respects. I conclude that while Call et al. have identified intriguing evidence, further research is required to rule out alternative explanations and to better understand employees' motives.

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1. Introduction

Call et al. (2016) investigate the role of stock options grants to rank and file employees in facilitating misconduct. They report two key results. First, they find that firms subject to class action litigation grant relatively more options to rank and file employees. They interpret this result as evidence that management use the options to incentivize employees to be complicit in misconduct. Second, they find that among firms subject to class action litigation, those that grant more options to rank and file employees are less likely to experience whistleblowing allegations. They interpret this result as evidence that the options discourage rank and file employees from whistleblowing.

Taken at face value, Call et al.'s (CKR hereafter) findings suggest that employee stock options are routinely used to induce rank and file employees to be complicit in corporate misconduct. While the interpretation offered by CKR is intriguing, I think it remains open to question in several respects. Perhaps most importantly, CKR fail to provide evidence that employees benefit from being complicit in corporate misconduct. Furthermore, as I will describe in more detail below, stock options appear to be a cumbersome way of inducing employees to be complicit in corporate misconduct. But if options are not inducing employee complicity in corporate misconduct, then how do we explain CKR's results? At the very least, CKR have provided important and intriguing evidence that highlights the need for further research in this area. In the remainder of this discussion, I raise some questions about CKR's interpretation, offer some alternative potential explanations and provide suggestions for future research.

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2. How do rank and file employees benefit?

Perhaps the most limiting aspect of CKR's analysis is the lack of any evidence that employees actually benefit from the alleged complicity in corporate misconduct. CKR focus exclusively on a sample of firms that are subject to class action lawsuits for violating securities laws. Such lawsuits are typically associated with substantial declines in stock price. CKR present no evidence to suggest that employees are able to cash in their options ahead of these lawsuits. Indeed, as I will discuss in more detail below, in most cases it seems implausible that employees would have had time to do so. Thus, CKR appeal to the argument that other firms have probably engaged in corporate misconduct that has avoided discovery, and that it is in these other undocumented cases that employees benefit from their options. While this is certainly a possibility, claims made in the paper, such as "firms grant rank and file options to share inflated profits with employees" (see this issue) seem premature.

If rank and file employees do not benefit from their options, then why do CKR document a positive relation between employee option grants and corporate misconduct? I see at least two other explanations for why top executives who are engaging in financial misconduct may want to use employee stock options in place of cash compensation. First, financial misconduct is more likely to occur in firms that are cash constrained and facing difficulty in raising capital (e.g., [Dechow et al., 1996](#)). Faced with limited cash, managers of such firms may be more likely to use stock options to compensate employees. Second, if executives have indeed engaged in corporate misconduct that has led to the temporary overpricing of their company's stock, then they may view their own overpriced stock as a relatively cheap way to compensate employees.

3. Puzzling timeline

A second puzzling aspect of the story in CKR is the apparent implausibility of the timeline that would be required for options to be effectively used to incentivize employees to be complicit in financial misconduct. Fig. 1 in CKR provides a hypothetical timeline. First, management formulates a plan to engage in financial misconduct (e.g., misreporting). Next, management issues stock options to employees. Once the stock options are issued, CKR hypothesize that employees are more likely to be complicit in financial misconduct. Thus, the period of financial misconduct can commence. In the sample examined by CKR, the median class period over which misreporting occurs is 272 days. The next event to occur in CKR's timeline is that a lawsuit is filed. The median time between the end of the class action period and the filing of a lawsuit is just 28 days. The puzzling aspect here is that employee stock option plans typically have vesting periods that range from one to four years. So in the cases examined by CKR, option vesting typically occurs after the financial misconduct has ended and a class action lawsuit has been filed. At this point, the misconduct is discovered and reflected in stock price, so there is unlikely to be any financial benefit to employees from supporting the misconduct.

CKR argue that while employees do not receive benefits in the cases examined in their paper, there are probably undiscovered cases of corporate misconduct where employees do benefit. Consequently, employees may still expect benefits *ex ante*, even though the employees in their sample do not receive benefits *ex post*. This argument is puzzling and requires elaboration. Is it plausible for financial misconduct to routinely go undiscovered for multiple years? If not, employee stock options do not seem like a very effective method for incentivizing employees to be complicit in corporate misconduct. An immediate salary increase, or a bonus tied to short-term earnings would seem to be more effective. A key feature of employee stock options is that they provide incentives for long-term value creation rather than short-run profits. It therefore seems odd that CKR find that stock options provide incentives for short-run misconduct.

One possible way to rationalize the results is to argue that there are some cases of short-run corporate misconduct that go undiscovered and ultimately lead to long-term stockholder value creation. For example, management could have inside information concerning valuable future growth opportunities. If they are unable to credibly communicate this information to investors, short run misconduct may be the only way to raise the capital to exploit these growth opportunities. Once the growth opportunities materialize, the profits from these growth opportunities can be used to cover up any inflated profits stemming from the misconduct. Employees may be in a better position than investors to appreciate these growth opportunities, and granting them options could incentivize them to assist management in executing the short run misconduct. While offering one rationalization for the results, this argument requires a number of strong assumptions and has no direct empirical support.

4. Managerial motivations

CKR choose to take corporate misconduct as a given and focus on whether stock options deter employee whistleblowing. In my mind, this represents a missed opportunity, because understanding why management engages in misconduct should be useful in understanding why employees are willing to be complicit. For example, if management were trying to achieve short-term objectives, such as boosting an earnings-based bonus or boosting stock price ahead of a secondary offering, it would seem inconsistent to incentivize employees to be complicit via long-term options. On the other hand, if management were trying to boost the value of their own long-term stock options, then the use of options to incentivize employees would

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