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Why do CFOs become involved in material accounting manipulations?☆

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ABSTRACT

This paper examines why CFOs become involved in material accounting manipulations. We find that while CFOs bear substantial legal costs when involved in accounting manipulations, these CFOs have similar equity incentives to the CFOs of matched non-manipulation firms. In contrast, CEOs of manipulation firms have higher equity incentives and more power than CEOs of matched firms. Taken together, our findings are consistent with the explanation that CFOs are involved in material accounting manipulations because they succumb to pressure from CEOs, rather than because they seek immediate personal financial benefit from their equity incentives. AAER content analysis reinforces this conclusion.

1. Introduction

Recent corporate accounting scandals have led to significant losses for investors, triggered a series of corporate governance reforms and legislative changes, and prompted efforts to identify the underlying causes of these scandals. Prior research has focused on the incentives of CEOs or the executive team as a whole to manipulate accounting earnings

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(e.g., Burns and Kedia, 2006; Bergstresser and Philippon, 2006). However, there is little research on the incentives and role of Chief Financial Officers (CFOs) in material accounting manipulations.[1]

We investigate the CFO's role in accounting manipulations for two reasons. First, CFOs typically oversee the process of preparing financial reports and are viewed as watchdogs for financial reporting quality. For firms with accounting manipulations, the CFOs have failed in their monitoring role. Moreover, relative to other executives, CFOs are in a unique position to carry out accounting manipulations, such as structuring transactions, choosing an improper accounting method, or making false journal entries.[2] Second, while previous studies have investigated the CEO's role in accounting manipulations (e.g., Efendi et al., 2007), CFOs may undertake accounting manipulations for different reasons than CEOs, as their job responsibilities and compensation structure differ. Given that CFOs are subordinates of CEOs, examining CFOs' involvement in accounting manipulations also provides insights into the implications of corporate organizational structure (e.g., the relationship between CFOs and CEOs) for financial reporting quality.

To address our overarching research question, we consider two explanations for CFOs' involvement in accounting manipulations. On one hand, CFOs may instigate accounting manipulations for immediate personal financial gain. For example, the former Chairman of the Federal Reserve Board, Alan Greenspan, argues that too many corporate executives (including CFOs) artificially inflate reported earnings in order to harvest stock market gains. Corporate boards seem to concur with this view and have reduced CFOs' incentive compensation after passage of the Sarbanes-Oxley Act (e.g., Indjejikian and Matejka, 2009). Jiang et al. (2010) also provide archival evidence that CFO equity incentives are more important than CEO equity incentives in explaining earnings management, measured by accruals and frequency of meeting earnings benchmarks. On the other hand, CFOs may become involved in accounting manipulations because of pressure from CEOs. As CFOs' superiors, CEOs can influence various decisions related to CFOs' future career opportunities and compensation, which in turn enables CEOs to exert pressure on CFOs regarding financial reporting decisions (Matejka, 2007).

While we cannot directly observe either CFOs' personal motivations or the interactions between CEOs and CFOs to explain why CFOs become involved in material accounting manipulations, we provide indirect evidence to identify the more likely explanation for CFOs' involvement – CFO as an instigator versus CFO acquiescing to CEO pressure.[3] Specifically, using a comprehensive sample of firms that were subject to SEC enforcement actions for manipulating financial reports, we analyze various costs and benefits experienced by CFOs who are involved in accounting manipulations. We also complement this analysis by examining the role of CFOs in accounting manipulations as described by the SEC in the enforcement releases.

We summarize our analyses as follows. We find that about 60 percent of CFOs of manipulating firms are charged by the SEC in the enforcement releases, and the charged CFOs face penalties such as future employment restrictions (i.e., being banned from serving as an officer, director, or accountant for any public company), fines, disgorgement, and criminal charges. However, CFOs of manipulation firms do not exhibit higher pay-for-performance sensitivities than CFOs of a control sample. Therefore, CFOs seem to bear substantial legal costs for committing accounting manipulations yet reap limited immediate financial benefits via equity incentive compensation. In contrast, CEOs of manipulating firms exhibit higher pay-for-performance sensitivities and power (i.e., the CEO is more likely to be Chairman of the Board and a founder, and more likely to have a higher share of the total compensation of the top five executives) than CEOs of non-manipulating firms. The association between manipulation and CEO power is stronger for firms with CEOs having high equity incentives. Thus CEOs appear to benefit via higher equity incentives and have the power to pressure CFOs to undertake manipulations.

Moreover, we find that CFOs are more likely to leave the companies prior to the accounting manipulation period, consistent with some CFOs losing their jobs because they refuse to participate in accounting manipulations under CEO pressure. Finally, our analysis based on the content in Accounting and Auditing Enforcement Releases (AAERs) suggests that CEOs are more likely than CFOs to be described by the SEC as having orchestrated the accounting manipulations as well as having benefited financially from the manipulations. Taken together, our findings are consistent with the explanation that CFOs become involved in accounting manipulations under pressure from CEOs, rather than instigating such manipulations for immediate personal financial gain.[4]

[1] We define material accounting manipulation to be earnings management activities that violate Generally Accepted Accounting Principles (GAAP).

[2] For example, Scott Sullivan, former CFO of WorldCom, admitted that he knowingly made most of the illegal accounting decisions.

[3] Note that we do not suggest that these two explanations are mutually exclusive. However, identifying the primary explanation is important for corporate governance reform since these two explanations have different policy implications. For example, if CFOs become involved in material accounting manipulations primarily because they are pressured by CEOs, reform efforts should also consider improving CFOs' independence from CEOs in addition to redesigning compensation packages. We also discuss other potential explanations for CFOs' involvement in accounting manipulations in footnote 4.

[4] Our evidence does not appear to provide support for the following alternative explanations. First, instead of pressuring the CFO, the CEO may bribe the CFO to manipulate earnings by increasing the CFO's equity incentive compensation. However, if this is the main explanation, CFOs of manipulation firms would have higher equity incentives than CFOs of matched firms, which is not what we find. Second, CFOs might also instigate accounting manipulations if the firm is performing poorly and the CFO expects to lose his/her job. However, if this is the main explanation, we would not expect to observe more powerful CEOs in manipulation firms. Furthermore, if CEOs create a corporate culture focusing on meeting earnings targets and CFOs (not CEOs) would be fired if earnings targets are not met, then this scenario would be consistent with our "CFO pressured" explanation. Third, CFOs and CEOs might collude to orchestrate the accounting schemes. If there is implicit pressure in such collusion, it would still be consistent with the "CFO pressured" explanation. If CFOs only attempt to please CEOs, again we would not expect to observe manipulation firms' CEOs to be more powerful.