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The role of tax regulation and compensation contracts in the decision to voluntarily expense employee stock options[☆]

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Abstract

We show that firms with executive bonuses that qualify for deduction under Internal Revenue Code Section 162(m) were less likely to expense stock option compensation (SOC) in 2002. Additionally, the more likely it is that a qualified firm will incur re-contracting costs, the less likely it is that the firm will expense SOC. CEOs of qualified firms that also expense SOC receive smaller bonuses than CEOs of expensing firms that are not qualified under 162(m), and the lower 162(m) bonuses are not offset by higher SOC. Our results suggest that 162(m) tax incentives are an important determinant of the decision to expense SOC.

JEL classification: M41; J33; H25; G38

Keywords: Management contracting; Taxes; Stock options; Shareholder voting; Section 162(m)

1. Introduction[1]

In response to increased demand for earnings transparency, many firms voluntarily expensed stock option compensation (SOC) in advance of SFAS 123(R) (Aboody et al., 2004). We investigate whether this decision is

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[1]Walter Blacconiere passed away at the age of 50 on March 4, 2007. Walt received his bachelor's and master's degrees in accounting from the University of Illinois and his Ph.D. in accounting from the University of Washington in 1988. He also taught at the University of Southern California and as a visiting faculty member at INSEAD (Singapore). He joined the accounting faculty of the Kelley School,

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influenced by re-contracting costs arising from Internal Revenue Code (IRC) Section 162(m). Under 162(m), cash compensation in excess of $1 million is tax-deductible only if based on objective, shareholder-approved performance goals. Performance goals are typically income-based, and the voluntary expensing of SOC is likely to reduce income to below bonus plan targets. To avoid reducing bonuses, qualified-162(m) firms that prefer to expense SOC must re-contract, give up the 162(m) deduction, or postpone voluntary expensing.[2]

Our study is important for three reasons. First, research shows that 162(m) unintentionally contributes to higher pay (e.g., Rose and Wolfram, 2002; Harris and Livingstone, 2002; Balsam and Ryan, 2006). We show that 162(m) also discourages the adoption of income-decreasing accounting methods. Second, we find that mandatory shareholder approval of compensation plans slows adaptation to changes in the disclosure environment. This finding is applicable beyond 162(m) due to the increased use of performance-based equity plans that require shareholder approval (ISS, 2005). Finally, we show that financial reporting, tax, and contracting costs are economically significant determinants of the expensing decision, but that financial reporting costs are the most important. Firms with high SOC are 165% less likely to expense, while qualified-162(m) firms are 49% less likely to expense, and firms with low re-contracting costs are 43% more likely to expense.

We examine 57 firms that expensed SOC during 2002 and 57 industry-asset matched controls. We focus on 2002 because events such as the passage of the Sarbanes-Oxley Act of 2002 unexpectedly increased the demand for transparent reporting choices such as SOC expensing, leaving insufficient time for qualified-162(m) firms to adjust bonus targets. Consistent with our two hypotheses, we find that qualified-162(m) firms are less likely to recognize SOC and that the likelihood of recognition is lower for qualified-162(m) firms with significant re-contracting costs. In particular, qualified-162(m) firms with higher SOC and less flexible bonus plans are less likely to expense SOC.

We also examine the joint impact of 162(m) qualification and voluntary recognition on CEO bonuses. Qualified-162(m) expensing firms paid lower 2002 bonuses than non-qualified expensing firms. In contrast, 162(m) qualification is unassociated with bonus levels at non-expensing firms. Further, qualified-162(m) expensers did not shift from bonus pay to options.

The remainder of the paper is organized as follows. Section 2 develops our two hypotheses. Section 3 presents our sample, model, and results. Section 4 concludes.

2. Background and hypotheses

IRC 162(m) requires that shareholders approve the material terms of a bonus plan and that the compensation committee fix performance targets before the 90th day of the fiscal year. These requirements deter the unanticipated voluntary adoption of income-decreasing accounting methods. Assume, for example, that a qualified-162(m) firm with an income-based performance metric initiates SOC expensing, but did not intend to expense when shareholders approved the bonus plan and the compensation committee fixed the bonus target.[3] The firm faces the following choices: (1) pay the higher bonus amount intended by the compensation committee at the time the target was fixed (i.e., a bonus based on income that excludes SOC expense), but lose the 162(m) tax deduction, or (2) pay the smaller bonus based on the new accounting method, but maintain 162(m) qualification. The firm could subsequently "re-contract" by adjusting targets for the effect of expensing, but this alternative would not be available in the initial year.

(*footnote continued*)
Indiana University in 1994, where he was an Ernst & Young Faculty Fellow for many years. Walt was the recipient of numerous teaching awards. He served on the editorial board of The Accounting Review and authored numerous articles in top-tier accounting journals. Warm, generous, and thoughtful, Walt will long be remembered as an outstanding teacher, a selfless colleague, and an insightful scholar. Walt is survived by his wife Michelle and children Mia (17), Eva (15), and Michael (10). The Blacconiere College Fund has been established to honor Walt and to support his children in college. If you wish to contribute to this fund, please make your contribution payable to College Choice 529 Investment Plan. Send contributions to: Blacconiere College Fund, c/o Daniel M. Matthews, Hilliard Lyons, P.O. Box 1849, Bloomington, IN 47402-1849, USA.

[2]We use the term "qualified-162(m) firm" to indicate a firm whose compensation committee designs executive compensation to qualify as tax deductible under the performance-based exception of Section 162(m).

[3]Perry and Zenner (2001) document that the typical plan's performance goals are based on an accounting income metric (i.e., net income, earnings per share, return on equity, and/or return on assets).