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Accounting rules? Stock buybacks and stock options: Additional evidence

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ABSTRACT

This paper finds that CEO stock options influence the choice, amount, and timing of funds distributed as a buyback. These results favor a managerial opportunism motive for buybacks over other theories and support two key research expectations – that buybacks impose option-induced agency costs on outside shareholders, and that managers benefit from weak governance and unclear accounting in this choice. CEOs increase their insider selling following a buyback, which also supports a managerial opportunism perspective. Once we control for these agency factors, we find no evidence that buyback activity associates reliably with EPS accretion from the reduction in common shares. We conclude that the popular use of stock buybacks as a form of cash distribution derives significantly from a strong contemporaneous relation between buybacks and CEOs' use of stock options as additional compensation.

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1. Introduction

US companies spent almost one trillion dollars on stock buybacks in 2007, a record amount that exceeded dividends paid and approximated almost two-thirds of net income that year. Since 2000, those same companies used buybacks to return well over three trillion dollars to shareholders.¹ By any measure, these amounts evidence a substantial distribution of cash to shareholders. This paper focuses on why executives and boards spend such substantial sums. We posit that, among several factors, CEOs' stock options and accounting rules, both of which have changed since 2000, play a key role in this regard. Our results support two primary research expectations: first, that the choice and amount of a buyback relate significantly to CEOs' option compensation and, second, that weak governance and unclear accounting further influence this relation. Both relations create agency costs – in the former case from conflicts of interests and in the latter case as a result of accounting arbitrage.² We find no evidence that buyback activity associates reliably with the EPS accretion from share reduction once we control for these factors.

First, we model the company choice to repurchase shares or pay additional dividends. Second, we examine the determinants of the dollar amount and number of shares repurchased. Third, we investigate the timing link between buybacks and stock option compensation. Fourth, we test for factors to explain investor reaction to a buyback announcement. Fifth, we

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¹ Similarly, Lazonick (2010) reports that 438 S&P500 companies spent \$2.4 trillion during 1997–2008.

² We view *accounting arbitrage* as a form of regulatory arbitrage, whereby a regulated company seeks an advantage from the difference between its real or economic risk and the regulatory position. In keeping with this view, we define accounting arbitrage as the economic benefit – as reflected in agency costs – conferred on managers and others from the application of accounting rules and regulations; in this case, those related to stock buybacks and stock options. Such accounting rules and regulations need not be improper.

examine how option-induced agency costs may influence the relation between CEO shares repurchased and CEO insider trading around a buyback.

We report the following results. First, the number of exercisable stock options and those held by the CEO and a lower option exercise price increase the likelihood that a company chooses a buyback over a dividend increase. Buyback companies also exhibit higher CEO compensation and weaker governance proxies than dividend increase companies. Second, when we focus on the determinants of buybacks, we find that buyback outlay associates positively with CEO compensation and the number of options granted to and exercisable by the CEO. Third, the link between buybacks and stock option exercise in general and by CEOs in particular reflects a contemporaneous rather than a sequential relation. Fourth, while the average three-day excess stock return around a buyback announcement is 1.78%, investors discount this response for companies with higher option grant values and higher CEO compensation. Investors also experience significantly negative stock returns 6 months around the announcement (other than a positive announcement effect), so that the average outside shareholder receives no benefit. Fifth, underperforming buybacks, which unclear accounting and disclosure rules may encourage, associate reliably with higher stock option benefits for the CEO. We find no evidence, on the other hand, that buyback activity associates reliably with the EPS accretion. Sixth, we find that elevated insider selling by CEOs following a buyback relates positively to the buyback amount, which further supports the view that CEOs use buybacks opportunistically to enhance compensation through stock options. These results are new to the literature.

1.1. Related literature

We build upon an extensive literature about companies' motives for a buyback and how the stock market reacts to buyback announcements.³ Buyback proponents advance several reasons for a buyback such as taxes, takeover deterrence, financial restructuring, payout flexibility, signaling, undervaluation, free cash flow, earnings per share (EPS) management, and, more recently, stock option compensation.

Several studies (Dann, 1981; Vermaelen, 1981; Ofer and Thakor, 1987; Bartov, 1991; Comment and Jarrell, 1991) emphasize the use of a buyback as a signal to reduce information asymmetry between managers and outsiders. Similarly, managers may use a buyback to signal their intention to distribute excess free cash flow to shareholders that might otherwise create agency costs from unwise or inefficient decisions (Jensen, 1986; Nohel and Tarhan, 1998; Oded, 2005; Chan et al., 2006). These studies document a positive, short-window market response of about 3–4% to open market repurchase (OMR) announcements in 1980s (Vermaelen, 1981; Ikenberry et al., 1995). This declines to about 1–2% for OMRs in 1990s (Kahle, 2002). Studies of the longer-term impact of buybacks also show positive returns (45% excess return over 4 years for undervalued shares (Ikenberry et al., 1995) and 21% over 3 years for Canadian companies (Ikenberry et al., 2000). These studies relate positive long-window return to favorable subsequent events (e.g., successive earnings surprises); although their results, based on post-buyback return, have been scrutinized on methodological grounds (Mitchell and Stafford, 2000).

A second set of studies (Bens et al., 2003; Hribar et al., 2006; Lewis and White, 2007; Balachandran et al., 2008; Gong et al., 2008) relates buybacks to companies' efforts to manage EPS or return on equity (ROE). EPS rises when a buyback reduces weighted average shares (the denominator in the calculation of EPS) more than it reduces net income (e.g., from foregone interest income). ROE (net income divided by shareholders' equity) also rises when the reduction in shareholders' equity from the buyback (e.g., from Treasury or cancelled shares) more than offsets the reduction in net income.⁴ These studies contend that managers use such "improved" accounting numbers to reinforce their optimism about the company's future prospects and to buttress an undervaluation argument.

A related set of studies concentrates on the use of a buyback to offset the dilutive effects of exercised or exercisable stock options. Under the Treasury stock method of calculating diluted EPS, outstanding stock options increase weighted average common shares, which decrease EPS. A buyback, on the other hand, decreases weighted average common shares, which increase EPS (subject to foregone interest income). Bens et al. (2003) find a positive relation between buybacks and exercisable stock options for this reason. Lee and Alam (2004) also find a positive association between EPS dilution from stock options and the probability of a buyback. Balachandran et al. (2008) report evidence of accruals management prior to a buyback when such companies have exercisable options, presumably to enhance payoff and return to option holders. Babenko (2009) finds an incentive effect of stock buybacks, consistent with the use of buybacks to counter dilution.

However, if investors view buybacks as a form of earnings management, then they will reduce the positive effects of signaling by the negative effects of earnings management. Hribar et al. (2006) report that investors discount buyback-induced EPS accretion around an earnings announcement.

³ For comprehensive reviews, see Dittmar (2000), Grullon and Ikenberry (2000), and Weston and Sui (2002). Our literature review is not intended to cover the entire field (or array of motivations for a buyback); which dates back at least to Ellis and Young (1971) on the costs and consequences of buybacks. Open market repurchases, for example, could be used as a takeover deterrent (Billett and Xui, 2007).

⁴ ROE is also inflated because the buyback at current market prices offsets shareholders' equity at book value, that is, the sum of the recognized assets less recognized liabilities.

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