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Excess perks and stock price crash risk: Evidence from China ☆

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ABSTRACT

We investigate the impact of excess perk consumption on crash risk in state-owned enterprises in China. To enjoy excess perks, executives in state-owned enterprises have an incentive to withhold bad news for extended periods, leading to higher future stock price crash risk. Consistent with this assertion, we find a positive correlation between excess perks and crash risk. The findings are robust to the inclusion of other determinants of crash risk identified in the literature, such as earnings management, conditional conservatism, and firm-level corporate governance mechanisms. The results still hold after accounting for possible endogeneity issues using a two-stage least squares estimation. Earnings management (conditional conservatism) helps amplify (lessen) this impact. Moreover, better external monitoring mitigates the impact of excess perks on firm crash risk. We further find that the impact of excess perks on crash risk is more pronounced in firms whose executives are approaching retirement and persists for at least two years.

1. Introduction

We investigate whether executives' excess perk consumption is positively correlated with their firms' future stock price crash risk (hereafter crash risk). Apart from the easily observable and quantifiable pecuniary portion of compensation, such as base salary, bonus, restricted stocks, and stock options, another important non-pecuniary portion of compensation is perk consumption. Equity-based compensation, such as stock options, purporting to align the interests of shareholders and executives, generate unintended adverse consequences. For instance, Benmelech et al. (2010) provide a model and Kim et al. (2011b) offer empirical evidence to show that firms' equity-based incentives are positively correlated with their crash risk. However, whether perk consumption increases crash risk has been seldom explored in the literature due to the limited availability of perk data.

China's capital market offers us an opportunity to investigate the impact of perk consumption on crash risk. First, unlike the US studies, quantifiable perk expenses are disclosed voluntarily by Chinese listed firms, providing the necessary perk data for this study.

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[1] In the sample period of Gul et al. (2011), perk expense data were available for about 34% of Chinese firms.

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In our sample period, detailed perk expense data were available for about 39% of Chinese firms.[1] Second, Chinese firms seldom use equity-based executive compensation schemes (such as stock options and performance-based stock grants), so executive monetary compensation consists mainly of a base salary and cash bonuses. Due to regulatory restrictions on cash compensation to executives of state-owned enterprises (SOEs),[2] perks constitute an important part of compensation to entice managers to perform (Gul et al., 2011). Hence, perks have become an important element of managers' total compensation package and warrant more investigation. Lastly, China has become one of the largest and fastest growing economies across the globe since its economic reform in the early 1980s. Perk consumption control, as part of corporate governance, affects the confidence of not only domestic but also international investors.[3]

Perks may arise due to optimal employment contract design and managerial productivity enhancement (Fama, 1980; Rajan and Wulf, 2006), but they may also be created by managers to divert resources from the firm for their own private benefit (Jensen and Meckling, 1976; Yermack, 2006). However, it is hard to determine ex ante whether perk consumption enhances productivity or simply diverts resources. For example, it is difficult to determine whether a chauffeur-driven luxury car or a giant corner office is strictly necessary for the accomplishment of managerial duties and productivity enhancement. It may be simply a waste of firm resources, since an ordinary car or the executive works only in a small portion of the office could suffice. Therefore, our study focuses on the excess portion of executive perk consumption, which is arguably more likely to be a resource diversion.

We contend that executives' excess perk consumption can lead to high crash risk for the following reasons. First, excess perk consumption is a direct resource diversion from the company to executives, which reduces firm value. However, because of its hidden compensatory nature, it is easier for executives to disguise this type of resource diversion among productivity enhancement types of perk consumption. To hide such inefficient resource consumption, executives will depict the efficient use of resources by hiding bad news from investors. Second, excess perks encourage executives to focus on short-term results and neglect long-term concerns. To enjoy more perks, executives will try to build up their empire by pretending to have valuable investment opportunities, which is, in turn, masked by presenting the firm's good performance. The aforementioned diversions of firm resources incentivize executives to withhold bad news for extended periods. Bad news hoarding eventually reaches a tipping point and leads to a stock price crash. However, strong external monitoring makes it harder for executives to withhold bad news from investors and, in turn, can mitigate the impact of excess perk consumption on crash risk.

Our findings support our hypotheses. First, our results suggest that excess perks are positively correlated with crash risk in SOEs in China. Our conclusions are robust to the inclusion of other determinants of crash risk identified in the literature, such as earnings management, conditional conservatism, and firm-level corporate governance mechanisms. This result implies that bad news hoarding incentives arising from perk consumption incrementally contribute to crash risk over and above other predictors identified by previous crash risk research. More importantly, the results still hold after accounting for endogeneity issues using a two-stage least squares (2SLS) estimation. Second, we find that earnings management amplifies the impact of perk consumption on crash risk, while conditional conservatism mitigates it. This finding suggests that financial opacity (such as earnings management) facilitates bad news hoarding while conditional conservatism limits executives' opportunities to withhold bad news, which is in line with the literature (Hutton et al., 2009; Jin and Myers, 2006; Kim and Zhang, forthcoming-a,b). Third, we find that strong external monitoring mitigates the impact of excess perk consumption on crash risk. More specifically, we find that Big Four auditors, higher institutional ownership, cross-listing in Hong Kong, and better institutional development help lessen the impact. Finally and interestingly, we find that the impact of excess perks on crash risk is more pronounced in firms whose executives are approaching retirement and persists for at least 2 years.

We contribute to the literature in different ways. First, we extend the literature on perks to include a firm's crash risk exposure. That is, the adverse impact of perks goes beyond accounting and stock return performance. Rajan and Wulf (2006) provide evidence that perks are offered to enhance managerial productivity while, in stark contrast, Yermack (2006) reports that perk consumption is one type of company resource diversion and reduces shareholder returns. Using Chinese data, Luo et al. (2011) suggest that high levels of perks hurt firm operating efficiency and Gul et al. (2011) report that greater perks are associated with a lower quality of financial reporting. To our best knowledge, our paper is the first study relating perks to crash risk and adds to the recent stream of literature on the economic consequences of excess perks beyond a firm's accounting and stock return performance.

Our paper is also related to the emerging literature of crash risk. Chen et al. (2001) find that a series of variables, such as investor heterogeneity and stock return volatility, will predict firm crash risk. Additionally, other studies find that financial opacity (Hutton et al., 2009; Jin and Myers, 2006; Kim and Zhang, forthcoming-b), corporate tax avoidance (Kim et al., 2011a), conditional conservatism (Kim and Zhang, forthcoming-a), and CEO and CFO equity incentives (Benmelech et al., 2010; Kim et al., 2011b) will affect crash risk. We add to the literature by finding one more factor, excess perk consumption, which relates to crash risk. It is worth pointing out that our study is especially related to the disincentives arising from executive compensation in terms of crash risk (Benmelech et al., 2010; Kim et al., 2011b), since it identifies an important non-monetary compensation, perks, as associated with crash risk.

The rest of the paper is structured as follows. Section 2 introduces the institutional background of perk consumption in China. Section 3 reviews the literature and develops our testable hypotheses. Section 4 presents the sample and variable measurement. Section 5 reports the empirical results and Section 6 concludes the paper.

[2] Regulatory restrictions on cash compensation to executives of SOEs will be detailed in Section 2.1.

[3] In some cases, executive perks have caught the attention of government officials. For instance, China Petrochemical Corporation spent over RMB 1 million to buy one light fixture to decorate its office headquarters in 2009. In response to such excess perks, Premier Wen Jiabao openly criticized China's SOEs in early 2012 (http://news.ifeng.com/mainland/detail_2012_03/26/13455009_0.shtml, last accessed January 21, 2013).