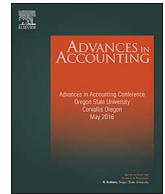




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Unanticipated effects of restricted stock on managers' risky investment decisions

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ABSTRACT

We conduct a laboratory experiment to examine whether holding periods for stock compensation affect managers' willingness to take large risks for their firms in order to pursue personal gains. The theoretical lens through which we examine these issues involves the concepts of current-self (the person you are now) and future-self (the person you will be in the future). Results indicate that long holding requirements can decrease manager's feelings of connectedness to their future selves. This change in decision perspective increases managers' willingness to accept risks for their firms when the potential personal rewards of risk taking are high. The findings call into question the current view held by regulators and academics that long holding requirements will consistently reduce adverse consequences of performance-based executive compensation. We find that long holding requirements can actually increase managers' willingness to pursue investments with very low chances of success when large performance incentives are available.

Compensation structures are critical for controlling manager behavior and are intended to align managers' interests with those of shareholders. The 2008 financial crisis revealed that compensation structures that include stock and stock options can promote excessive risk taking by managers as they seek to obtain personal financial gains. Significant reforms have been made in attempts to better align manager's interests with the long-term interests of shareholders, often with a focus on compensation structures. In recent years, regulators and academics have promoted and evaluated compensation structures designed to reduce managers' pursuit of personal, short-term gains at the expense of taking massive risks for their firms (Bebchuk & Fried, 2010; Bebchuk, Cohen, & Spamann, 2009; U.S. House of Representatives 2008). For example, the Troubled Asset Relief Program (TARP) requires that recipients of federal funds pay executives primarily with restricted stock, and it further requires that 50% of all restricted stock received as compensation be held for three years before it can be sold. The purpose of such holding requirements is to curb managers' risk-taking at the firm level for the sake of acquiring personal financial benefits. The TARP incentive policies attempt to control manager behavior by requiring “that the majority of salaries be paid in stock that must be held for the long term—giving executives incentives to pursue long-term value creation and financial stability” (Feingold, 2009).

It is currently widely believed and accepted that stock holding

requirements similar to those created by the TARP are beneficial and cause managers to focus on long-term firm effects instead of their own short-term interests. Compensation experts suggest that the optimal solution for aligning manager behavior and shareholder interests and curbing risk taking that may not benefit the firm requires that compensation be tied to long-term performance, and current recommendations for achieving this objective often involve holding requirements that are more restrictive than those in the TARP (Bebchuk & Fried, 2010; Bebchuk et al., 2009; Bhagat & Bolton, 2014; Bhagat & Romano, 2009). For example, some researchers have recommended that stock should be held until after a manager/executive departs the firm, such as 4 years after resigning from the firm (Bebchuk et al., 2009; Bhagat & Bolton, 2014; Bhagat & Romano, 2009).

While long holding requirements are espoused by many, and their use has grown rapidly since the financial crisis, very recent research has begun to evaluate their effects on governance and the ethical behavior of management. In archival analyses of stock option grants and financial malfeasance, Call, Kedia, and Rajgopal (2015) find that holding requirements can be used by firms to constrain whistleblowing because employees whose pay is tied to long-term firm performance cannot afford the adverse effects on firm value that result from blowing the whistle on corporate fraud. Thus, stock restrictions can interfere with governance mechanisms and potentially promote undesirable behavior.

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We continue this line of research and respond to the call for “researchers need to consider issues beyond the determinants of executive compensation and its firm-performance outcomes and analyze the ethics and effects of executive compensation” (Verstegen Ryan, Buchholtz, & Kolb, 2010). We propose that there is another unanticipated threat to manager behavior created by long holding requirements that has not previously been considered.

The current research examines the potential for stock holding requirements to influence how connected managers feel to their future selves. Research finds that decisions made for one's future-self differ from those made for one's current-self, as many individuals believe that the person they will be in the future (future-self) will be quite different from the person they are today (current-self) (Parfit, 1971, 1987). Changes in feelings of connection to one's future self can influence risk taking and one's focus on personal incentives. In this light, we conduct an experiment to examine whether the holding requirements found in the TARP (three-years) and recommendations for extended holding requirements beyond a manager's departure from the firm affect managers' feelings of connection to their future selves and their willingness to accept substantial investment risks for their firms. We anticipate that there are unintended effects of long holding requirements, which arise because relatively long holding requirements change decision perspectives to the distant future and decrease managers' feelings of connectedness to their future-selves.

Results of the experiment indicate that shorter holding periods (such as those included in the TARP) had little effect on managers' risk taking relative to no holding requirements, but longer holding requirements induced significantly greater risk seeking. Managers were willing to put their firms at much greater risk and invest in projects with an 85% chance of failure in order to pursue performance-based pay when their compensation included the requirement to hold stock compensation until after retirement or departure from the firm, but the managers were less willing to seek high levels of investment risk for the firm when there were no holding requirements or when holding requirements were three years.

It appears that the long holding requirements that are recommended to focus managers on long-run performance have unintended consequences. Long holding requirements can induce willingness to pursue investments with very high risks of failure when managers have opportunities to earn large financial rewards. Overall, findings from the experiment call into question the current view that long holding requirements are consistently beneficial for the firm.

1. Background and hypothesis

1.1. The current-self and the future-self

The philosopher Parfit (1971, 1987) proposed that individuals think of their future-selves much like they think of strangers. That is, individuals feel disconnected from their future-selves, and they expect to be very different people in the future, relative to the present. Whether such changes in personality actually take place is not critical, as it is the belief that such changes will occur that affects decisions.

Several contemporary studies have directly tested the philosophical arguments of Parfit (1971, 1987). For example, Pronin, Olivola, and Kennedy (2008) found that the decisions individuals make for their future-selves are similar to decisions they would make for others (strangers), and decisions individuals make for their current-selves differ from decisions they would make for their future-selves or others. They conducted a series of four experiments where participants were asked to make decisions such as whether they would drink a disgusting liquid in order to help advance science or take risky action to help a person in need. Pronin et al. (2008) demonstrated that people were more concerned about the well-being of their current selves than their future selves (i.e., they took fewer risks for their current selves), and people made similar decisions for their future selves that they would

make for strangers. Overall, their results reveal that individuals treat their current and future selves differently when making decisions.

Studies of brain activity also support the notion that individuals view their future-selves differently than current-selves. Ersner-Hershfield, Wimmer, and Knutson (2009) scanned individuals' brains after asking them to think about themselves in the present, themselves in the future, or a stranger. Functional MRI results indicated that the same regions of the brain were activated when thinking about one's future-self and strangers. However, different regions were activated when thinking about one's current-self. Related to this research, Ersner-Hershfield, Garton, Ballard, Samanez-Larkin, and Knutson (2009) asked individuals to choose between receiving a sum of money immediately versus receiving an amount in the future. They found that individuals with the greatest differences in brain activation between their current-selves and future-selves needed more money in the future to be willing to delay their reward. Thus, perceptions that the future-self is different than the current-self caused individuals to apply greater discount rates to the value of a future reward.

In a series of experiments, Ersner-Hershfield et al. (2009) demonstrated that individuals who see their future-self as less similar to their current-self accumulate fewer actual financial assets for retirement than do individuals who see their future-self as more similar to their current-self. The authors conducted both laboratory and field experiments where individuals made decisions about how much to spend now versus how much to save for the future. In both the laboratory and real life, individuals who perceived more similarity between their current and future selves saved more and spent less on their current selves.

Overall, archival, neurological and behavioral studies support the notion that decisions vary for one's current-self versus future-self, and individuals view their future-self as being different than their current-self. Importantly, research also finds that feelings of connectedness to the future-self change decisions related to ethics and risk. In multiple experiments, Hershfield, Cohen, and Thompson (2012) find that individuals who feel more connected to their future selves are less likely to favor unethical business decisions and are less likely to lie in order to achieve personal gains. Importantly, the authors also run an experiment where they manipulate feelings of connectedness to one's future self by asking individuals to focus on their future selves. Hershfield et al. (2012) find that the contextual cues can effectively change feelings of connectedness to one's future self, and contextual cues that increase connection to the future-self reduce unethical behavior. Thus, perceptions of connectedness to one's future-self have both dispositional and contextual components, and our research focuses on the effects on context on feelings of connectedness. That is, we examine the potential for elements of compensation structure to alter connectedness to one's future self.

There is also prior evidence of a general tendency to neglect one's future-self and others in favor of one's current-self (see e.g., Camerer, 2003; Diekmann, Ross, & Bazerman, 1997; Pronin et al., 2008). Research into the mechanisms that drive favoring of the current-self versus the future-self suggests that individuals are more concerned about the personal consequences of decisions for their current-selves, relative to future-selves or others (Pronin et al., 2008). There is a propensity to focus on the concrete effects of decisions on one's personal costs and benefits for the current-self. However, future-selves are treated more like others, and less concern is given to personal consequences when individuals do not feel connected to their future selves (Pronin et al., 2008).

Taken together, existing psychological research finds that contextual factors (such as compensation schemes) can change feelings of connectedness to the future-self, individuals express decreased concerns for the well-being of the future-self, and individuals take more risks for the future self. These findings lead us to consider potential effects of current versus future-self connectedness on managers' risk taking behavior because a lack of concern for personal consequences has the capacity to promote significant risk-taking behavior. We propose that

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