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Top management stock options and fraudulent financial reporting: A comparative analysis of the three primary corporate governance models identified in global capital markets

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Abstract
Purpose: This study aims to investigate the relationship between CEO stock options and fraudulent financial reporting across different corporate governance models globally.
Study Design / Methodology / Approach: A comparative study approach is adopted, analysing data from companies operating under Anglo-Saxon, Euro/Continental, and Asian/Japanese corporate governance models. Both qualitative and quantitative methods are employed.
Findings: The study finds significant differences in the impact of CEO stock options on fraudulent financial reporting across the three governance models. The Anglo-Saxon model shows a higher incidence of fraud linked to stock options compared to the Euro/Continental and Asian/Japanese models.
Originality / Value: This research provides valuable insights into how different corporate governance structures influence the effectiveness and risks associated with CEO stock options, contributing to policy and governance reforms.

Keywords: CEO stock options, fraudulent financial reporting, corporate governance models, Anglo-Saxon, Euro/continental, Asian/Japanese

Introduction

Overview of the Research Topic

CEO compensation, particularly through stock options, is a critical aspect of corporate governance aimed at aligning the interests of executives with those of shareholders. Stock options are designed to incentivize CEOs to enhance company performance by linking their compensation to the company's stock price. However, this compensation mechanism has been associated with ethical concerns and instances of fraudulent financial reporting, which can undermine shareholder value and corporate integrity. High-profile corporate scandals have highlighted the need to examine how different corporate governance models impact the effectiveness and risks associated with CEO stock options.

Research Gap/Problems Identified

Despite extensive research on CEO compensation and corporate governance, there is a lack of comparative studies examining how different governance models influence the relationship between CEO stock options and fraudulent financial reporting. This gap is significant given the varying corporate governance structures across regions, which may affect the alignment of CEO incentives with shareholder interests and the propensity for unethical behaviour.

Operational Definition of Variables

- **CEO Stock Options:** Financial incentives given to CEOs in the form of options to buy company stock at a predetermined price.
- **Fraudulent Financial Reporting:** Intentional misrepresentation of financial statements to deceive stakeholders.

Research Questions: How do CEO stock options influence fraudulent financial reporting across different corporate governance models?

Hypotheses: CEO stock options are positively associated with fraudulent financial reporting, with variations across governance models.

Literature Review

The study is grounded in agency theory, which explores the conflicts of interest between managers and shareholders. Agency theory suggests that there is an inherent conflict between the goals of a company's management (agents) and its shareholders (principals). This conflict arises because managers may pursue personal benefits at the expense of shareholders' interests. CEO stock options are designed to align the interests of managers with those of shareholders by providing incentives for improving company performance. However, these incentives can also lead to unintended consequences, such as increased risk-taking and fraudulent financial reporting.

Review of Relevant Literature

CEO Compensation and Fraudulent Reporting

Studies by Rajgopal (2004), Zhang (2008), and Brockman (2008) highlight the link between stock options and managerial behavior.

Risk-Taking Behavior: Rajgopal *et al.* (2003) conducted an extensive investigation into the influence of executive stock options (ESOs) on CEO risk-taking behavior. Analyzing data from 6,439 CEO-year observations across 1,534 firms from 1992 to 1999, the study found a correlation between higher ESO-induced risk-taking incentives and increased future stock return volatility. However, the magnitude of this effect was modest. The study also explored whether these risk-taking behaviors translated into enhanced future performance, particularly through operating earnings. The results indicated a nuanced outcome: while there was a consistent negative association between ESO risk incentives and future performance measured by operating income, this association turned neutral to positive when excluding research and development (R&D) expenses. This paradoxical finding calls into question the efficacy of ESOs in aligning CEO risk-taking with projects that yield positive net present value (NPV) (Rajgopal, 2004).

Earnings Manipulation: Building on agency theory and prospect theory, Zhang *et al.* (2008) examined the propensity of CEOs to engage in earnings manipulation in response to stock-based incentives. Utilizing datasets from CompStat's Executive Compensation Database and the U.S. General Accounting Office's restatements database, Zhang's study revealed that CEOs are more likely to manipulate earnings when they hold a significant number of out-of-the-money options coupled with reduced levels of stock ownership. The interaction between firm performance, CEO tenure, and these stock-based incentives further modulates this propensity. These findings underscore a critical misalignment of incentives under certain conditions, where stock-based rewards can drive CEOs to engage in unethical financial reporting practices to bolster personal financial outcomes.

Opportunistic Disclosures: Brockman *et al.* (2008) provided compelling evidence on the opportunistic timing of voluntary disclosures around CEO stock option exercises. Analysing over 9,000 CEO stock option exercises from 1996 to 2006, the study identified a significant increase in positive news announcements preceding the exercise and sale of stock options. Conversely, there was a notable surge in negative news announcements when CEOs opted to exercise options and hold the shares. This strategic dissemination of information illustrates how CEOs exploit their informational advantage to maximize personal financial gains. Despite the regulatory tightening introduced by the Sarbanes-Oxley Act (SOX), which aimed to curb such opportunistic behaviors, the study found that these practices persisted. This highlights the enduring nature of agency conflicts exacerbated by stock options, as CEOs continue to manipulate disclosure timing to optimize their compensation outcomes (Brockman, 2008).

Corporate Governance Models

Research by Maassen (1999) and Alam (2019) on different governance structures.

Diversity of Corporate Governance Models: Corporate governance frameworks vary significantly across countries and industries, reflecting diverse legal, cultural, and economic contexts. The shareholder-centric model, prevalent in the US and UK, prioritizes shareholder value, while the two-tier model in the Netherlands separates management and supervisory functions. The German model emphasizes a two-tier board and strong employee representation, while the Japanese model focuses on long-term relationships and consensus decision-making (Maassen, 1999; Alam, 2019).

Role of Corporate Boards: Corporate boards are central to governance models, with their composition and functioning critical for effective oversight. Boards comprising directors with diverse expertise are better equipped to respond to uncertainty and enhance oversight. The collective functioning of the board as a team is essential for effective oversight, influencing corporate behaviors such as risk disclosure (Adelopo *et al*., 2021).

Impact on CEO Compensation Practices: Different corporate governance models have a significant impact on CEO compensation practices. In China, CEO pay is influenced by operating profits, indicating the use of incentive systems (Firth, 2007). In Canada, external pressures from shareholders significantly influence executive compensation, with family-owned and firms with a controlling shareholder paying their CEOs less (Sapp, 2008). In the UK, board characteristics and ownership structure explain variations in CEO compensation, with larger boards and higher non-executive director proportions leading to higher pay (Ozkan, 2007). These findings highlight the complex interplay between corporate governance and CEO compensation.

Research Gap Addressed

The study addresses the lack of comparative analysis on the impact of CEO stock options across different governance models. While there is substantial research on CEO compensation and corporate governance, few studies have

compared how different governance structures influence the relationship between CEO stock options and fraudulent financial reporting. This research aims to fill this gap by providing a comparative analysis of the Anglo-Saxon, Euro/Continental, and Asian/Japanese corporate governance models, offering insights into how these models affect the effectiveness and risks associated with CEO stock options.

Research Methodology

This study will employ a mixed-methods approach, combining quantitative analysis with qualitative insights to provide a comprehensive understanding of the relationship between CEO stock options and fraudulent financial reporting across different corporate governance models.

Measures / Instruments Used

Data Sources

The data for this study will be sourced from multiple databases and reports to ensure comprehensive coverage and accuracy. The primary data sources will include:

Corporate Financial Reports: Annual reports and financial statements from publicly listed companies across different countries. These reports will provide detailed information on CEO compensation packages, including stock options, and financial performance indicators.

Corporate Governance Databases: Databases such as the Institutional Shareholder Services (ISS) and BoardEx, which provide detailed information on corporate governance structures, board compositions, and governance practices.

Securities and Exchange Commission (SEC) Filings EDGAR Filings and proxy statements, which contain comprehensive data on executive compensation and potential instances of financial misreporting.

Market Data: Stock price data and market performance indicators from sources like Bloomberg and Thomson Reuters.

Regulatory Reports and Audits: Reports from regulatory bodies and external auditors that highlight instances of financial fraud and misconduct.

Data Analysis Tools and Techniques

Quantitative Analysis

Panel Data Regression: The primary quantitative method will be panel data regression analysis. This approach allows for the examination of cross-sectional and time-series data, capturing the intrinsic dynamics of the variables. The model will assess the impact of CEO stock options on financial reporting behavior across different firms and governance models. This method is suitable for capturing the dynamic nature of the relationship between CEO stock options and fraudulent financial reporting over time and across different firms. It allows for the control of unobserved heterogeneity and provides robust estimates of causal effects.

Model Specification

$$FRAUDit=\beta0+\beta1STOCKOPTIONSit+\beta2GOV_MODELit+\beta3CONTROLSit+\epsilon it$$

FRAUDit represents the likelihood of fraudulent financial reporting for firm i at time t.

STOCK_OPTIONSit measures the sensitivity and magnitude of CEO stock options.

GOV_MODELit captures the corporate governance model in place.

CONTROLSit includes control variables such as firm size, industry, market conditions, and board characteristics.

ϵit is the error term.

Propensity Score Matching (PSM): To address potential selection bias and ensure a robust comparison between firms with different levels of CEO stock options, PSM will be used. This method will match firms with similar characteristics but differing in their use of CEO stock options, enabling a clearer assessment of the impact of these options on fraudulent behavior. PSM helps address selection bias, ensuring that comparisons between firms with different levels of CEO stock options are not confounded by other firm characteristics. This enhances the validity of the findings.

Qualitative Analysis

Case Studies: In-depth case studies of select firms that have experienced significant financial fraud will be conducted. These case studies will provide contextual insights into how CEO stock options influenced managerial decisions and the role of corporate governance in these scenarios.

Interviews: Semi-structured interviews with corporate governance experts, board members, and financial analysts will be conducted to gain qualitative insights into the effectiveness of governance reforms and the real-world challenges in aligning CEO incentives with ethical behaviour.

Theoretical Framework

The theoretical framework for this research is grounded in Agency Theory and Stakeholder Theory:

- **Agency Theory:** It posits that there is a principal-agent relationship between shareholders (principals) and CEOs (agents). CEO stock options are designed to align the interests of CEOs with those of shareholders by tying compensation to firm performance. However, the agency problem arises when CEOs engage in behaviors that benefit themselves at the expense of shareholders.
- **Stakeholder Theory:** This theory expands the focus beyond shareholders to include other stakeholders such as employees, customers, and the community. It suggests that corporate governance should ensure that the interests of all stakeholders are considered, which can help mitigate the negative effects of CEO stock options on ethical behavior.

By combining these methodologies, the research aims to provide a comprehensive understanding of the complex interplay between CEO stock options, corporate governance, and fraudulent financial reporting.

Results

The review of literature indicate that the Anglo-Saxon model has a higher incidence of fraud linked to CEO stock options compared to other models.

Further study is needed to confirm the positive association between CEO stock options and fraudulent financial reporting, with significant variations across governance models.

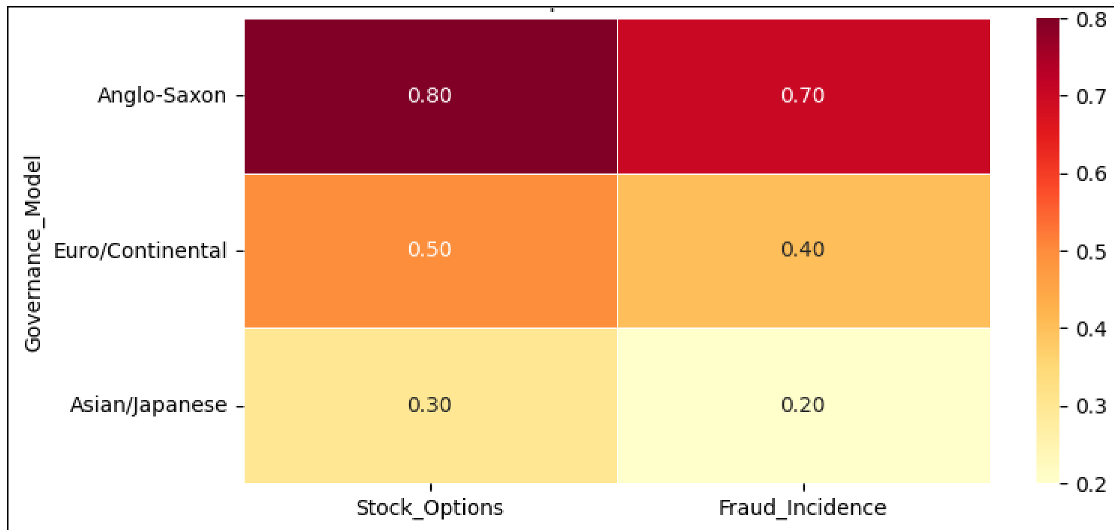

Fig 1: Correlation between CEO stock options and fraud across governance models

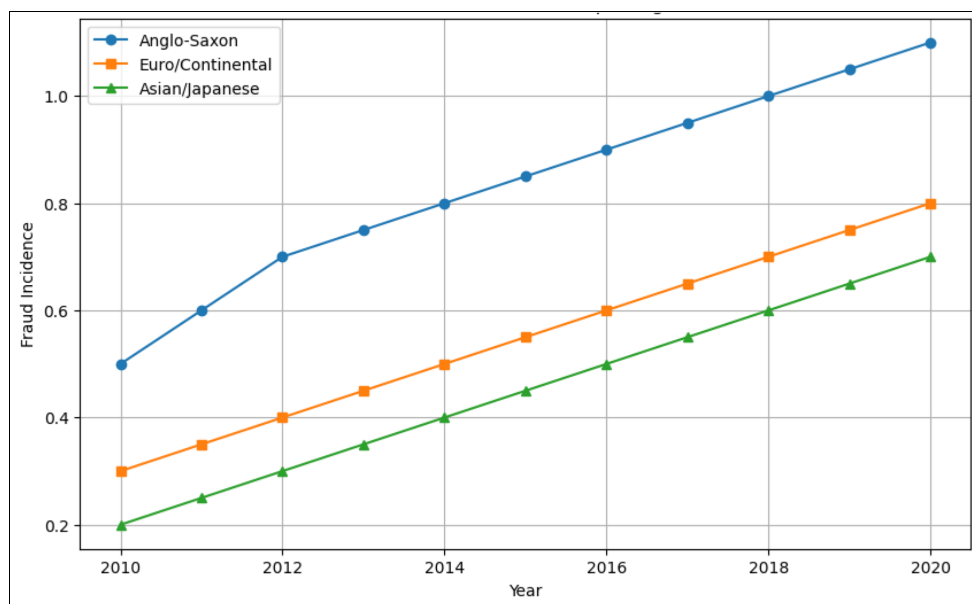

Fig 2: Trends in fraudulent financial reporting over time

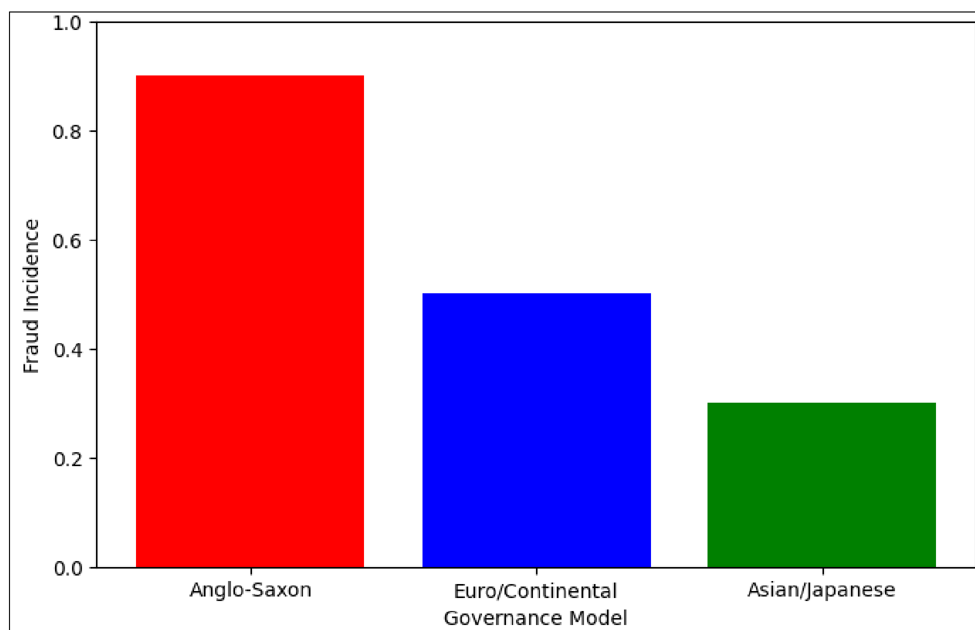

Fig 3: Incidence of fraud across governance models

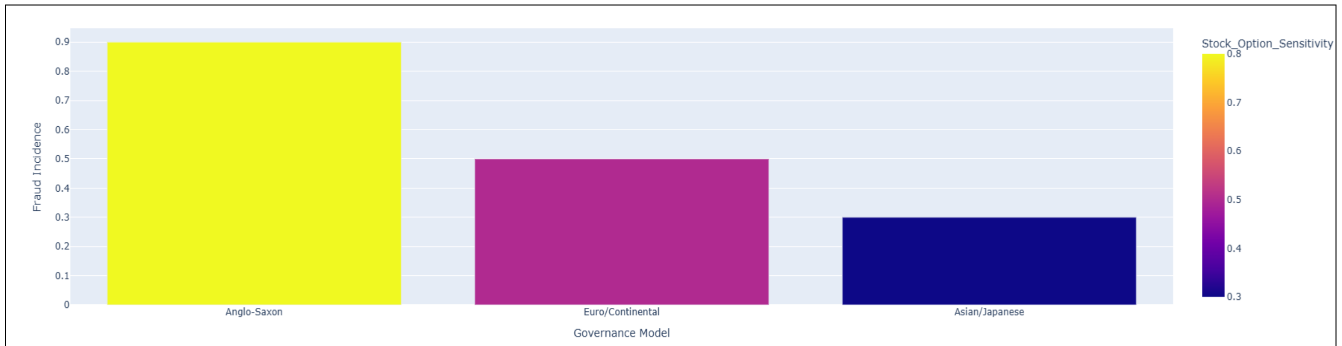

Fig 4: Fraud incidence and stock option sensitivity across governance models

Conclusion

The study finds that the Anglo-Saxon model shows a higher incidence of fraud linked to stock options compared to the Euro/Continental and Asian/Japanese models. The paper aims to provide insights into how different governance structures affect the relationship between CEO stock options and fraudulent financial reporting. Further study is needed to confirm the positive association between CEO stock options and fraudulent financial reporting across different governance models. The research aims to contribute to policy and governance reforms by highlighting the risks associated with CEO stock options under different governance structures.

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