

Is There a Relationship Between Management Compensation and Revenue Misstatements?

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The potential relationship between management compensation and financial misstatements has been examined in a number of studies. These studies have yielded mixed results on the question of whether management compensation structures may be related to the probability of a firm misstating its financial statements. Part of the reason for the inconsistent results may be the practice of measuring compensation variables during (or at the end of) the misstatement period. Such a measurement approach can mix both the potential *cause* of misstatements and the *effects* of the misstatements. In our study, the compensation variable measurements were taken from the time period immediately prior to the beginning of the misstatement period. This technique ensures that our measures reflect whether compensation may have led to a misstatement, rather than capturing how the misstatement itself may have affected the compensation. Our findings indicate that both CEO salary and CEO bonus were lower for firms misstating revenue than for our matching firms. This result suggests that CEOs with lower cash compensation are motivated to misstate revenue to increase their compensation to levels more comparable to their peers. We also find that managers of misstatement firms held more stock options than managers of their non-misstating peer firms, indicating that management with more stock options may have greater incentive to misstate their financial statements.

INTRODUCTION

Misstated financial statements¹ have drawn much attention in the past decade. Interest has risen especially in the wake of discoveries of large-scale misstatements and bankruptcies (e.g., Enron, WorldCom, Global Crossing, etc.). Research in this area generally follows two

¹ In our study, the term “restatement” is used to refer to the firm’s changing their financial statements to correct a previous “**misstatement**.” The original misstatement is of interest; the restatement is used to identify the misstatement.