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Earnings Management and Stock Option Plans

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Abstract

This paper examines earnings management when the corporation introduces stock option plans. Management has the incentive to manage the accounting earnings because its compensation depends on the difference between the exercise price determined on the stock option grant and market price on the exercise date. If the announcement to decrease profits makes an impact on the market price, management prefers earnings-decreasing accounting policy (negative discretionary accruals) in the introduction of the stock option plan because the exercise price depends on the market price around the introductory date. The corporation usually determines the exercise price of stock options on the basis of market price around the introductory date of stock options in Jápan. Our results do not support this hypothesis. We find a positive relation between discretionary accruals and the introduction of stock option plans. There are two reasons management prefers earnings-increasing accounting policy. Firstly, the stock options have hardly any impact on the compensation of management because most of the compensation consists of the non-equity pay. Secondly, the management has the intention of increasing market price by the introduction of stock options. Management would like to raise the market price by implementing the earnings-increasing accounting policies in accordance with the introduction of the stock option plans. In fact, we find a positive relation between market price and discretionary accrual on the corporation by introducing the stock option plan.