

# **Do Executive Stock Options Generate Incentives for Earnings Management? Evidence from Accounting Restatements <sup>1</sup>**

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## **Abstract**

In a sample of 224 firms that announced restating their financial statements from January 1997 to June 2002 due to accounting irregularities and a control group of all non-restating firms with data on ExecuComp, we examine the effect of pay for performance incentives on the incentives for earnings management. Controlling for the endogeneity of pay for performance incentives, we find a significant positive effect of incentives on the probability of restating. In our sample, average value of executive option holdings increases by \$21 for every \$1000 change in equity value. Increasing incentives by 90 cents or 4.3% from the above mean increases the probability of restatement by 1%. We find that stock and options differ in the incentives generated for earnings management. There is no evidence that equity holdings generate incentives for earnings management. Further, large managerial ownership mitigates the positive effect of stock options on the incentive to manage earnings.

Keywords: Executive Stock Options, Compensation, Accounting Restatements, Earnings Management.

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