Illegal backdating: Small firms get a free pass

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(PhysOrg.com) -- Smaller companies are more likely than larger firms to commit illegal backdating of executive stock options but are less likely to be punished, say researchers at the University of Michigan.

"There are numerous instances in the law where small firms have been granted exemptions from regulatory restrictions due to a disproportionate effect on these companies," said Cindy Schipani, professor of business law at U-M's Ross School of Business. "Our results show that small firms, although not exempted from regulation prohibiting undisclosed backdating and not less culpable than large firms, have been spared the bulk of law enforcement."

In a new study of more than 6,000 public companies from 2002 to 2005, Schipani and Ross School colleagues M.P. Narayanan and H. Nejat Seyhun, along with Deniz Anginer of the World Bank, estimate nearly 500 firms engaged in illegal backdating during this time, of which about 100 were implicated (investigated or prosecuted).

They found that the average size of all backdating firms as measured by the variable market capitalization was smaller than that of all firms in general ($213 million vs. $284 million). On the other hand, the average size of implicated backdating firms ($1.83 billion) was much greater than that of all firms overall.

"This implies that smaller firms are less likely to comply with regulation, at least in the case of backdating, raising doubts about the wisdom of exempting small firms from regulations or their enforcement," said Seyhun, professor of finance at the Michigan Ross School. "The result that implicated firms are larger than average while backdating firms are smaller is consistent with the view that prosecutorial choice plays a role in the selection of firms for investigation and cautions against policy prescriptions based on observed investigations or prosecutions."

According to the study, which is forthcoming in the New York University Journal of Legislation and Public Policy, firm size, size of compensation and financial performance are all determining factors of whether a company will be investigated or prosecuted for illegal backdating.

The researchers found that implicated firms have fewer independent board directors and their CEOs have longer tenure compared to firms on average---indicating weaker corporate governance. However, on other observable metrics of governance such as one on the extent of shareholders' rights, implicated firms actually rank higher---even as they engage in legally and ethically questionable practices.

The financial performance of backdating firms, as measured by variable excess stock returns, is better than the sample of all firms on average, the researchers say. And the performance of implicated firms is significantly better on average.

"These results are not surprising," said Anginer of the World Bank. "Backdating is profitable only when stock returns are positive, and the firms that are targeted are likely to be those with very high stock returns and, concomitantly, very high potential benefits to its executives from backdating."

In addition to corporate governance and financial performance, CEO pay provides an interesting contrast between backdating and implicated firms relative to firms on average, the researchers say. Both total and option compensation of CEOs at implicated firms and total pay of CEOs at backdating companies are significantly higher than that of CEOs of all firms.

"These results are consistent with the notion that CEOs with a greater proportion of option compensation are more likely to engage in backdating and are more likely to be investigated and prosecuted," said Narayanan, professor of finance at the Michigan Ross School.

"Collectively, our findings indicate, at least in the context of backdating, that smaller firms are more likely to engage in illicit behavior, yet they are more likely to escape prosecution, making the observed investigations and prosecutions unreliable indicators for the purpose of policy recommendations regarding exemptions of small firms from regulation."

Provided by University of Michigan

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