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Charles Cullinan

Hui Du

Gail B. Wright

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# A test of the loan prohibition of the Sarbanes-Oxley Act: Are firms that grant loans to executives more likely to misstate their financial results? ☆

Charles P. Cullinan <sup>a,\*</sup>, Hui Du <sup>b,1</sup>, Gail B. Wright <sup>a,2</sup>

<sup>a</sup> *Bryant University, Smithfield, RI 02917, United States*

<sup>b</sup> *University of Texas – Pan American, Edinburg, TX 78539, United States*

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## Abstract

The Sarbanes-Oxley Act of 2002 was designed to improve the accuracy and reliability of financial reporting and prohibits public companies from granting loans to executives. Without considering the effects of executive loans on financial reporting, some researchers have questioned the appropriateness of the Act's loan prohibition [Kahle, K., Shastri, K., 2004. Executive loans. *Journal of Financial and Quantitative Analysis* 39 (4), 791–811; Henderson, M., Spindler, J., 2005. Corporate Heroin: A defense of perks, executive loans, and conspicuous consumption. *The Georgetown Law Journal* 93 (6)]. We examine whether executive loans are associated with financial misstatements. We find a significant association between executive loans and financial misstatements. Our results suggest that a relationship exists between the Sarbanes-Oxley Act's loan

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☆ Data were obtained from publicly available sources.

\* Corresponding author. Tel.: +1 401 232 6421; fax: +1 401 232 6319.

*E-mail addresses:* [cullinan@bryant.edu](mailto:cullinan@bryant.edu) (C.P. Cullinan), [huidu@utpa.edu](mailto:huidu@utpa.edu) (H. Du), [gwright@bryant.edu](mailto:gwright@bryant.edu) (G.B. Wright).

<sup>1</sup> Tel.: +1 956 381 3369.

<sup>2</sup> Tel.: +1 401 232 6068.

prohibition and the Act's objective of improving the accuracy and reliability of financial reporting.

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## 1. Introduction

In the aftermath of the Enron and WorldCom scandals, the US Congress passed the **Sarbanes-Oxley Act of 2002**. The objective of the Sarbanes-Oxley Act is to "...improve the accuracy and reliability of corporate disclosures" (H.R. 3763, page 1). Section 402 of the Act prohibits corporate loans to executives. The loan prohibition amendment was added late in the legislative process, with little congressional discussion of how prohibiting loans to corporate executives would enhance the Act's objective of improving financial reporting and disclosure.

Some recent research has asserted that executive loans may be useful, without considering the potential effects of these loans on financial reporting accuracy. For instance, **Kahle and Shastri (2004)** indicated that their research, which focused on whether executive loans are used for stock purchases, "call[s] into question the wisdom of a sweeping ban on all loans to executives...". **Henderson and Spindler (2005)** assert that executive loans create a dependency between the executive and the firm, and call the loan prohibition provision of Sarbanes-Oxley "severe overreaching". The chair of the Senate Banking Committee has also indicated that he plans to hold hearings to determine whether portions of the Sarbanes-Oxley Act should be scaled back or repealed (**Labaton, 2005**).

We empirically examine whether granting executive loans in the pre-Sarbanes-Oxley period was associated with misstated financial statements. Specifically, we examine whether 106 revenue misstatements during the late 1990s and early 2000s were associated with companies' granting loans to their executives. We find that companies that granted loans to executives were significantly more likely to misstate their financial statements, suggesting that the anti-loan provisions of Sarbanes-Oxley are consistent with the Act's overall goal of enhancing the accuracy and reliability of financial reporting.

## 2. Background and research question

### 2.1. Research supportive of executive loans

Arguments in favor of executive loans (and thus not supportive of the anti-loans provisions of Sarbanes-Oxley) often focus on the use of these loans for exec-

utives to purchase the company's shares. For example, Rich and Jones (2005) notes that executive loans are often "intended to make it easier for executives to exercise their stock options and hold a larger number of shares." The expectation is that executives who own large amounts of company stock will be more likely to act in shareholder interests, because the executives are shareholders themselves.

Kahle and Shastri (2004) examined the reasons companies provided for granting executive loans, and found three main reasons: to buy stock, to exercise (and pay tax on the gain from) options, and for relocations. They also found that 64% of executive loans were secured with company stock, and that up to 12.6% of the loans were forgiven within the time of their study.

Kahle and Shastri (2004) also examined whether executives actually used the proceeds of stock and option loans for their intended purpose. Their overall results indicate that "a loan that enables a manager to buy 100 shares of stock results in only an eight-share increase in ownership" (Kahle and Shastri, 2004, p. 810). They attribute the small increase in share ownership to executives selling shares they already owned when new loans are granted. When they partition their sample into high and low pre-loan share ownership, they find that managers who own few shares when the loan is granted increase their share ownership substantially more than managers who already own a large number of shares. These results lead Kahle and Shastri (2004, p. 811) to "question the wisdom of an outright ban on these loans, especially for managers for whom ownership levels are low." Note that Kahle and Shastri (2004) did not consider whether loans may be associated with financial misstatements.

## 2.2. Research not supportive of executive loans

Arguments against executive loans (and thus in favor of retaining the loans prohibition of Sarbanes-Oxley) come mainly from two areas. The first is the observation that executive loans were evident in some recent instances of misstated financials; the second is evidence that shareholders are not supportive of executive loans.

### 2.2.1. Loans and misstatements

King (2002) examines the prevalence of executive loans. Of the top 1500 companies in the U.S., 510 companies (more than 33%) granted loans to executives for stock purchases prior to passage of Sarbanes-Oxley (King, 2002). He also finds that public companies with the largest executive loans outstanding were Adelphia Communications, WorldCom and Tyco, all of which have been involved in high profile financial statement misstatements in recent years.

One argument for why loans may be associated with misstatements is based on Henderson and Spindler's (2005) assertion that executive loans make the executive "more dependent" (p. 48) on the firm. While Henderson and Spindler contend that such dependency is "good" (p. 48), greater financial dependency

may also put pressure on executives to misstate financial results (AICPA, 2003). Jensen (2004) makes a similar point in suggesting that an excessive interest in value creation may create incentives to meet analysts' short run expectations, even if this requires misstating financial results to create the appearance of strong financial performance.

### 2.2.2. Shareholder perceptions of executive loans

Research examining shareholder perceptions of executive loans has generally found that shareholders do not view executive loans favorably. Ruxton (1999, cited in Thomas and Martin, 2000) finds that institutional investors often view loans, particularly those with below market interest rates, as preferential treatment of executives. Of the institutional investors surveyed by Ruxton, approximately 22% had a policy of not supporting stock option plans containing executive loan provisions.

Thomas and Martin (2000) examined factors associated with shareholder votes on stock option plans. They find that 24.8% of shareholders vote against plans that contain executive loan provisions, while only 16.4% of shareholders vote against plans that do not contain loan provisions, a difference that is statistically significant. They conclude that "Shareholders appear to disapprove of this practice [granting loans to executives]. . ." (Thomas and Martin, 2000, p. 68).

### 2.3. Legislative history of executive loans

Barnard (1989) notes that in the 1980s, many state corporate statutes, which previously disfavored executive loans, were amended to allow these loans if the board of directors determined that the loan "is expected to benefit the corporation." The issue of the propriety of executive loans again arose in 2002 in the aftermath of the Enron and WorldCom misstatements, when the Sarbanes-Oxley Act was adopted.

The Sarbanes-Oxley Act was first proposed in February 2002. In the original proposed Act, there was no provision prohibiting loans to executives (H.R.3763.RFS). Consideration for banning loans to executives appears to be linked to President Bush's speech on July 9, 2002 in which he called for "...compensation committees to put an end to all company loans to corporate officers" (Bush, 2002). Shortly thereafter, Senator Jay Rockefeller denounced executive loans on the floor of the Senate, saying "These loans are effectively theft from the employees and shareholders, since they represent revenue given in compensation which will never be repaid, reinvested, or distributed as dividends." (Rockefeller, 2002).

On July 12, 2002, Senator Charles Schumer proposed an amendment to the Sarbanes-Oxley Bill to prohibit loans to executives of public companies. His rationale for the amendment was the large number of instances in which companies involved in high profile misstatements, such as Enron, WorldCom and

Adelphia, had granted loans to executives. He then posed the question: “Why can’t these super rich executives go the corner bank like everyone else.” (Schumer, 2002). He concluded by asserting that “This is just wrong and it must be stopped.” With little debate or discussion, the amendment passed<sup>3</sup> and eventually was included in the final Sarbanes-Oxley Act as Section 402.

#### 2.4. Research question

Whether executive loans are associated with financial statement misstatements has not been previously examined. This issue is of particular relevance at a time when lawmakers are considering revisions to the Act, and when some researchers are criticizing the anti-loan provision. We therefore seek to examine the following research question: Are firms that grant loans to executives more likely to misstate their financial statements?

### 3. Research methods

#### 3.1. Sample

To examine whether loans to executives are associated with financial misstatements, we identified companies that had misstated their financial results using the GAO Restatement Database (GAO, 2003). This source provides information on publicly traded companies that restated their financial statements between 1997 and 2002. Note that while the restatements were disclosed during the 1997–2002 period, the misstatements often began in earlier periods.

We chose to focus on revenue misstatements due to their unambiguous effect on income and their prevalence during this time period (Beasley et al., 1999). The GAO database includes 329 companies (excluding repeated entries of the same misstatement) that misstated revenues. The list was reduced for foreign companies (11), entries that were erroneously identified as related to revenue (43), and entries for which the period involved could not be clearly determined (46). We also excluded 94 companies that restated in response to Staff Accounting Bulletin (SAB) 101 or EITF pronouncements.<sup>4</sup> Finally, 29

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<sup>3</sup> This amendment was one of only three (out of more than 90 proposed) to make it into the final bill. Ivanovich (2002) suggests that President Bush’s receipt of loans from his former employers was one of the reasons the loan prohibition amendment “went to the front of the line” (p. 1).

<sup>4</sup> Firms adopting SAB 101 were inconsistent in their accounting treatments. Some firms restated the previously issued quarterly results for the year in which SAB 101 was adopted, whereas others made no retroactive adjustments. Also, many companies restating for SAB 101 did so only for the previously issued quarters of the year in which the change was made, rather than changing all of the pre-SAB 101 periods. We would therefore be unable to determine the period when any actual misstatement may have began.

companies were eliminated due to insufficient disclosure in the proxy statements. Based on these restrictions, our final sample consists of 106 firms with financial misstatements.<sup>5</sup> Our sample may contain misstatements that are unintentional as well as intentional; the GAO database does not clearly distinguish between intentional and unintentional misstatements. If there are unintentional misstatements in the sample, and if executive loans are solely incentives to *intentionally* misstate, then our inclusion of these misstatements in our analyses would bias against finding significance on the loans variables.

To test whether executive loans are associated with misstatements, we identified a matching sample of firms that did not misstate their financial results during the same period. Matching firms were selected based on SIC code and firm size. We endeavored to match on 4 digit SIC code and for the matching company to have total assets within 20% of the misstatement firm's assets.<sup>6</sup> Seventy-four firms were matched using these criteria. Where such a match was not possible, we matched on 3 digit SIC codes and within 15% of asset size (14 firms), then a 2 digit SIC match within 10% of assets (18 firms).

Data on the misstatement and control firms were gathered from proxy statements of the year preceding the misstatement period. Given that our study was designed to assess whether loans to executives may have been associated with misstatements, it was most appropriate to examine whether executive loans were present when the misstatement began, rather than when the misstatement ended.

### 3.2. Loan measures

To determine whether loans were granted to executives, we searched the proxy statements for any mention of loans to executives. SEC regulations (Item 404(c) of regulation S-K) require disclosure in the proxy statement of any loans to executives over \$60,000.<sup>7</sup> Based on this information, two variables were developed. The first measure ("Loans granted") was coded 1 if the firm disclosed that they had granted loans to executives, and 0 if there was no disclosure of granted loans. The latter (0) category could include companies granting loans below the \$60,000 disclosure threshold. Our second measure of executive

<sup>5</sup> Our yield rate of 32.2% of firms in the final sample compares favorably to other research in the area such as Erickson et al. (forthcoming) who examined 287 misstatements, and included only 50 firms in their sample (a yield rate of 17.4%).

<sup>6</sup> Assets in the year preceding the beginning of the misstatement were used to avoid any potential effect of the misstatement itself on the matching criteria.

<sup>7</sup> In addition, some firms disclosed the *availability* of executive loans under the firm's stock option plans, but did not disclose that loans had actually been granted. In unreported analyses (with firms *granting* loans excluded), we found that the *availability* of loans was not significantly related to the probability of misstatement.

loans (“Dollar amount of loans outstanding”) was based on the disclosed dollar value of loans that had been granted to executives and were still outstanding.

### 3.3. *Control variables*

To control for other variables that have been shown to be associated with misstatements, we gathered information on variables falling into three categories: management compensation/financial interest, financial pressure facing the firm, and corporate governance. In the management compensation/financial interest area, we included variables found by previous studies to be related to misstatements (e.g., Johnson et al., 2004; Burns and Kedia, 2006; Efendi et al., 2004; Erickson et al., forthcoming). We include as a control variable CEO’s cash salary, which previous researchers have used to proxy for the extent to which an executive’s compensation is non-performance-based. CEO salary has generally been found to be lower for firms misstating their financial results. CEO bonus is also included (as a percentage of CEO salary). Previous researchers have used CEO bonus as a measure of the extent to which executives have been rewarded for their past performance. CEO bonus has yielded mixed results in the literature.

The number of options owned by executives is included to control for the possibility that executives with more options are more likely to misstate to ensure their options retain and/or increase their value. The percentage of shares owned by management is also included to control for the economic incentives managers may gain from an increased stock price due to misstatements. We also included two variables to measure the financial pressure facing the organization. These two variables are the firm’s financial leverage and whether the firm experienced a loss in the year preceding the beginning of the misstatement.

To control for corporate governance characteristics (e.g., Beasley, 1996; Abbott et al., 2004), we gathered data on the independence of the audit committee, as the literature suggests that independent audit committees may assist in preventing or detecting misstatement. We also included a variable reflecting the presence of a nominating committee, which may suggest board autonomy and enhanced governance. In addition, we collected data on whether the same person held the titles of CEO and Chair of the board (i.e., CEO/Chair duality), which some studies (e.g., Dechow et al., 1996) have suggested may weaken control and increase the probability of misstatement. The size of the board of directors was also included to control for the possibility that larger boards may have greater levels of expertise to prevent/detect misstatements. The percentage of the independent directors was also included, as some researches have noted that independent directors may have a greater ability to question management and thereby prevent or discover misstatements.

### 3.4. Testing techniques

We first developed descriptive statistics for executive loans in firms misstating their financial results and in firms not misstating their financial results. We then developed two logistic regression models to distinguish between firms that misstated and those firms that did not misstate. In Model 1, the independent variable of interest was the “Loans granted” variable, while in Model 2, the independent variable of interest is the “Dollar amount of loans outstanding” variable. Both regression models also included the control variables discussed above.

## 4. Results and limitations

### 4.1. Results

Descriptive statistics and bivariate results are presented in Table 1. For the measures of executive loans, firms that misstated their financial statements were more likely to have granted loans to executives than non-misstatement firms, and the dollar amount of loans was higher for misstatement firms than for non-misstatement firms. Both of these results are statistically significant. The control variables with significant differences between misstatement and non-misstatement firms include options owned by executives, and the presence of a nominating committee. CEO bonus and board size reflect marginally significant differences.

Results of the logistic regression models with misstatement as the dependent variable are presented in Table 1. Both models are significant at 0.001 (with  $\chi^2$ s of 36.79 and 39.89).<sup>8</sup> The percentages correctly classified (72.5% and 72.6%) indicate that the models provide material incremental explanatory power over a random model in which 50% of the firms would be correctly classified.

The loan measure in each model is highly significant. The positive sign on the loans variable in Model 1 indicates that firms that grant loans to executives are significantly more likely to misstate revenue than those firms that do not grant loans to executives. The results in Model 2 provide some evidence that the size of loans outstanding is associated with the probability of misstatement. These results suggest that executive loans make an important incremental contribution to our understanding of the type of firm that is more likely to misstate their financial statements.<sup>9</sup>

<sup>8</sup> An examination of collinearity diagnostics revealed no material concerns with collinearity.

<sup>9</sup> In unreported analyses, we logistically regressed loans against all of the control variables included in Table 2. Neither the overall model nor any of the individual variables were significant. This result suggests that the presence or absence of loans is unique contributory factor, and that granting loans is not a proxy for some other firm characteristic, such as weak governance structures. Note also that, in this model, loans were not associated with executive stock ownership.

Table 1  
Descriptive statistics and bivariate results

Loans measures	Misstatement firms	Non-misstatement firms	<i>T</i>	Two tail $p > T$
% of firm with loans granted	28.3%	11.3%	-3.16	0.0018
Dollar amount of loans outstanding <sup>a</sup>	\$924,031	\$223,143	-3.03	0.0028
<i>Control variables</i>				
CEO Salary	\$289,000	\$325,400	1.10	0.2739
CEO Bonus	46.4%	76.3%	1.97	0.0502
Options owned	2.4 million	1.1 million	-2.02	0.0444
% of shares owned	27.3%	23.0%	-1.45	0.1497
Audit committee independence	1.37	1.5	1.32	0.1877
% of firms with nominating committee	15.1%	28.3%	2.35	0.0196
% of firms with CEO/Chair duality	55.7%	59.4%	0.55	0.5805
Board size	6.95	7.58	1.85	0.0650
Percent independent directors	52.8%	55.9%	1.10	0.2709
Leverage	0.579	0.492	-0.82	0.4133
% of firms with loss	41.5%	33.9%	-1.13	0.2591
Sample size	106	106		

<sup>a</sup> *T* value based on log of dollar amount of loans outstanding due to the highly skewed distribution of the variable.

The control variables of CEO salary and CEO bonus were both marginally significant, except in Model 2 where CEO bonus was significant ( $p = 0.0497$ ). These results may suggest that CEOs of misstatement companies receive smaller cash salaries and bonuses than their peers. Larger amounts of options owned by executives are significantly related to misstatements. Taken together, the CEO salary, CEO bonus, and management options variables support findings in recent research (e.g., Erickson et al., forthcoming) that firms with more options-based, and less cash-based, compensation schemes are more susceptible to misstatement. Increased executive stock ownership is not related to misstatements, suggesting that increased managerial stock ownership does not inhibit misstatements. Neither leverage nor the loss variables were significantly related to the probability of misstatement.

Of the corporate governance control variables,<sup>10</sup> only the presence of a nominating committee is associated (marginally) with the probability of

<sup>10</sup> In addition to the control variables included in the model presented in Table 1, we also tested other control variables in unreported analyses. These other variables include audit committee financial expertise, number of audit committee meetings, blockholdings of stock, etc. The presence of these additional control variables did not affect the relationship between loans and misstatements. Inclusion of these additional control variables would also have materially reduced our sample size as a result of missing data for some of the variables. Given our focus on the potential effects of loans, we chose to use a more parsimonious model to maintain a reasonable sample size.

Table 2  
 Logistic regression results dependent variable: misstatement (0, 1) estimate ( $p > \chi^2$ )

Variables	Model 1	Model 2
Intercept	0.7027 (0.3258)	0.6897 (0.3347)
<i>Tested variables</i>		
Loans granted	1.2501 (0.0031)	
Dollar amount of loans outstanding		0.0968 (0.0030)
<i>Control variables</i>		
CEO Salary	-1.9842 (0.0719)	-1.9787 (0.0721)
CEO Bonus	-0.3238 (0.0728)	-0.3620 (0.0497)
Options owned	0.2292 (0.0221)	0.2216 (0.0275)
% of shares owned	0.5549 (0.4587)	0.5714 (0.4461)
Audit committee independence	-0.0406 (0.8709)	-0.0300 (0.9045)
Nominating committee	-0.7644 (0.0545)	-0.7667 (0.0543)
CEO/Chair duality	-0.0921 (0.7706)	-0.0842 (0.7900)
Board size	-0.0404 (0.5837)	-0.0414 (0.5759)
Percent independent directors	0.1571 (0.8630)	0.1847 (0.8395)
Leverage	0.1774 (0.4561)	0.1863 (0.4346)
Loss	-0.1595 (0.6318)	-0.1586 (0.6337)
<i>Model statistics</i>		
Model $\chi^2$	36.79	39.89
$p > \chi^2$	0.0004	0.0004
Sample size	212	212
Percentage concordant	72.6%	72.5%
Percentage discordant	27.1%	27.2%
Percentage tied	0.2%	0.3%
Adjusted-count pseudo $R^2$	0.452	0.450

*Variable definitions*

*Loan measures*

Loans granted	1 = If the firm has disclosed that loans were granted 0 = No loans granted
Dollar amount of loans outstanding	Dollar value of loans outstanding (logged) if loans have been granted (0 if no loans granted)

*Control variables*

CEO Salary	Salary earned by CEO
CEO Bonus	Bonus earned by CEO (as % of salary)
Options owned	Options held by top management group (in millions)
% of shares owned	Percentage of shares held by top management
Audit committee independence	2 = All audit committee members independent directors 1 = All audit committee members independent or grey directors 0 = Audit committee members include members of management
Nominating committee	1 = firm has nominating committee 0 = firms does not have nominating committee
CEO/Chair duality	1 = CEO and Board Chair are the same person 0 = CEO and Board Chair are different people

Table 2 (continued)

<i>Variable definitions</i>	
Board size	Total number of directors on board
Percent independent directors	Percentage of board members who are independent
Leverage	Debt/assets
Loss	1 = Firm had net loss year prior to misstatement 0 = Firm had net income year prior to misstatement

misstatement. While these results differ somewhat from earlier research (e.g., Beasley, 1996), the results are in accord with more recent research. For example, Baber et al. (2005) found that board of director independence is not associated with misstatements, while the absence of a nominating committee is associated with misstatements. These corporate governance results may suggest that the effectiveness of some governance mechanisms may have decreased as such practices as more independent directors became more widely adopted.

#### 4.2. Limitations

The results presented in this paper are limited by several factors. First, we only examined revenue misstatements. While revenue misstatements are the most common type of misstatement, results might have been different if other types of misstatements were included. Second, the period in which the misstatements occurred was prior to the passage of the Sarbanes-Oxley Act of 2002. Other provisions of the Act may have changed the potential relationship between loans and misstatements. Finally, the relationship between executive loans and misstatements may be related to an unmeasured variable, such as organizational culture, affecting both the presence of loans and the probability of misstatement. As such, we cannot necessarily conclude there is a causal relationship between loans and misstatements.

### 5. Conclusion

The Sarbanes-Oxley Act of 2002 was the congressional response to the collapse of several large corporations (e.g., Enron, WorldCom, etc.) and the losses in market value that affected many individuals' retirement and investment accounts. Its objective was to improve the reliability and accuracy of corporate financial reporting by, among other things, prohibiting personal loans to executives. The results presented in this paper suggest that firms that provide loans to executives are more likely to misstate their financial statement than firms that do not provide such loans. Despite recent calls for modification of the loan prohibition of the Act, our results support the effectiveness of the loan

prohibition provision, and suggest it will help to meet the Act's objective. Overall, our results support the efficacy of the loan prohibitions of the Sarbanes-Oxley Act in achieving the Act's objective of improving the accuracy and reliability of financial reporting.

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