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Managerial overconfidence and audit fees

Scott Duellman *, Helen Hurwitz, Yan Sun

Department of Accounting, John Cook School of Business, Saint Louis University, St. Louis, MO 63108, USA

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We investigate the association between managerial overconfidence and audit fees, as well as the effect of a strong audit committee on this relation. Overconfident managers tend to overestimate their ability and the future payouts of projects but underestimate the likelihood and impact of adverse events. If auditors perceive managerial overconfidence as increasing audit risk, they will charge additional fees to compensate for the increased audit effort. Conversely, audit fees for companies with an overconfident manager will be lower if managers demand less audit services due to either hubris in their companies' financial reporting or a desire to reduce auditor scrutiny over aggressive accounting practices. We find evidence of a negative relation between managerial overconfidence and audit fees for companies lacking a strong audit committee. Additionally, we find that overconfident managers are less likely to use an industry specialist auditor.

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1. Introduction

Auditing standards require auditors to consider management attitude when making audit risk assessments. A proper assessment of the "tone at the top" is important as executive attitudes can impact the audit risk of the company through the shaping of the moral, ethical, and social cultures of the organization (COSO, 2013). Consistent with auditors pricing executive characteristics, a spate of recent research has found that audit fees are related to executive equity incentives that can induce changes in risk taking (Billings et al., 2014; Chen et al., 2015; Fargher et al., 2014; Kannan et al., 2014; Kim et al., 2014). Furthermore, experimental research has linked managerial narcissism to increases in the auditors' assessed risk of client fraud attitude (Johnson et al., 2013). We extend this line of literature by examining the link between managerial overconfidence, a personality trait that affects risk taking and audit fees.

Managerial overconfidence could impact the financial reporting risk assessment of the auditor as overconfident managers tend to overestimate the projected future cash flows of projects but underestimate the likelihood and impact of adverse events (Heaton, 2002; Malmendier and Tate, 2005). Prior research has shown that overconfident managers are likely to use less conservative accounting (Ahmed and Duellman, 2013), misstate earnings given an earlier optimistic bias in earnings (Schrand and Zechman, 2012), issue a financial restatement (Presley and Abbott, 2013), engage in real earnings management (Hsieh et al., 2014), and maintain ineffective internal controls (Chen et al., 2014).

Despite the increased financial misstatement risk associated with managerial overconfidence, there is little evidence on whether auditors recognize characteristics indicative of managerial overconfidence and associate observed management overconfidence with increased audit risk. If auditors recognize managerial overconfidence, we expect auditors to

* Corresponding author. Department of Accounting, John Cook School of Business, Saint Louis University, St. Louis, MO 63108, USA. Tel.: +1 314 977 3862; fax: +1 314 977 1473.

E-mail address: duellman@slu.edu (S. Duellman).

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incorporate this risk factor in their audit planning and charge additional fees to compensate for the increased audit efforts to reduce detection risk. We refer to this effect as the financial reporting risk effect of managerial overconfidence.

Conversely, if overconfident managers do not value audit services as much as non-overconfident managers, they will seek to lower audit fees out of hubris over their companies' financial reporting process. A reduction in audit services will abate the need to respond to corrective feedback regarding the financial reporting of the company and allow more earnings management opportunities. This hubris effect of managerial overconfidence is consistent with previous studies showing that managerial overconfidence is associated with an optimistic bias in earnings (Schrand and Zechman, 2012), less conservative accounting (Ahmed and Duellman, 2013), greater real earnings management (Hsieh et al., 2014), and higher likelihood of earnings restatements (Presley and Abbott, 2013). If the financial reporting risk effect dominates the hubris effect, we expect a positive relation between managerial overconfidence and audit fees. Conversely, we expect a negative relation between managerial overconfidence and audit fees if the hubris effect dominates the financial reporting risk effect.

Although the Sarbanes–Oxley Act (Section 301) requires the audit committee to appoint, compensate, and oversee the auditor and the audit process, recent research suggests that management still wields significant influence over the audit process. For example, Cohen et al. (2010), based on interviews with 30 external auditors, conclude that management continues to be a driving force in the appointment and termination of auditors. Executives also have significant influence over the fees paid to auditors as Beck and Mauldin (2013) find larger audit fee reductions for influential CFOs during times of economic hardship.

Despite the ability of management to influence the audit process, previous research has demonstrated numerous benefits of a strong audit committee. For example, audit committee strength has been linked to higher audit quality (Abbott and Parker, 2000), lower levels of abnormal accruals (Klein, 2002), and better disclosure quality (Karamanou and Vafeas, 2005). Thus, through the use of more frequent and stringent internal audits, a strong audit committee effectively reduces the auditors' assessed client risk, which could mitigate a positive relation between audit fees and managerial overconfidence.

Alternatively, a strong audit committee will prevent management from interfering with the audit process or will purchase more audit services to offset the risks associated with managerial overconfidence. Consistent with a strong audit committee reducing the influence of management, Dhaliwal et al. (2014) find that companies with a strong audit committee are less likely to hire an auditor affiliated with the management. Therefore, a strong audit committee could mitigate a negative relation between managerial overconfidence and audit fees caused by the hubris effect.

To examine the relation between managerial overconfidence and audit fees, we use a sample of 7661 company-years with necessary data between 2000 and 2010. We use three measures of managerial overconfidence with one measure based on executives' option exercising behavior and two measures based on companies' investment decisions. Across all three measures, we find a significantly negative relation between managerial overconfidence and audit fees in the presence of a weak audit committee, which is consistent with the hubris effect of managerial overconfidence dominating the financial reporting risk effect. We also find evidence consistent with a strong audit committee mitigating the negative association between managerial overconfidence and audit fees.

Given the influence of managerial overconfidence on audit fees, we examine whether managerial overconfidence plays a role in the selection of the auditor. Previous research finds that audit fees are one of the most important determinants affecting auditor selection decisions and that specialist auditors charge significantly higher fees compared to non-specialist auditors (Craswell et al., 1995; Eichenseher and Shields, 1983; Ferguson and Stokes, 2002; Ferguson et al., 2003; Fung et al., 2012). Therefore, overconfident managers will be less inclined to use specialist auditors in order to lower audit fees. In addition, previous research has demonstrated that industry specialist auditors are better able to detect errors within their industry specialization (Bedard and Biggs, 1991; Owhoso et al., 2002; Wright and Wright, 1997). Thus, overconfident managers will seek to avoid specialist auditors who are more likely to reject aggressive accounting treatments. Consistent with our main analysis, we find a negative relation between managerial overconfidence and the use of a city-industry specialist auditor. However, we find only limited evidence that a strong audit committee mitigates the negative relation between managerial overconfidence and the auditor's industry expertise.

To mitigate the concern that companies with overconfident CEOs have company characteristics that are correlated with audit risk, we use propensity score matching to identify companies that are similar in characteristics but differ in the overconfidence of the CEO. Using a sample based on propensity score matching, we continue to find that, in the absence of a strong audit committee, managerial overconfidence is negatively associated with audit fees. These results suggest that differences in observable company characteristics are unlikely to be driving our results. Additionally, our findings are robust to the use of a treatment effects model to control for endogeneity and selection bias.

Our study contributes to the literature in several ways. First, to our knowledge, this is the first study that documents a negative relation between managerial overconfidence, a managerial personality trait, and audit fees.[1] This investigation adds

[1] Hribar et al. (2012) examine how counterparties (i.e., auditors and credit rating agencies) respond to managerial overconfidence and find a positive relation between audit fees and managerial overconfidence. These two studies differ in several important ways. First, we use three measures of managerial overconfidence based on executives' option exercising behavior and companies' investment decisions, while they rely on a press based measure and a factor based measure that considers the press based measure, CEO option exercising, and management forecast bias. Second, we also examine whether the audit committee plays a role in the relation between managerial overconfidence and audit fees. Third, we use a broader sample of companies, propensity score matching, and a treatment effects model to eliminate concerns that our results are driven by company characteristics.

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