



## Tournament incentives and corporate fraud<sup>☆</sup>



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### ABSTRACT

This paper identifies a new incentive for managers to engage in corporate fraud stemming from the relative performance evaluation feature of CEO promotion tournaments. We document higher propensities to engage in fraud for firms with strong tournament incentives (as proxied for by the CEO pay gap). We posit that the relative performance evaluation feature of CEO promotion tournaments creates incentives to manipulate performance, while the option-like character can motivate managers to engage in risky activities. We thereby extend previous corporate fraud literature that focuses mainly on equity-based incentives and reports mixed findings. Our results are robust to using different fraud samples, and controlling for other known determinants of fraud as well as manager skills.

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### 1. Introduction

Corporate fraud can have huge costs for shareholders, as evidenced by drops in market value of as high as 38% for firms accused of such behavior (Karpoff, Lee, and Martin, 2008a). To mitigate those costs, it is important to explore the incentives that lead to fraudulent behavior in corporations. Prior literature has primarily investigated how equity-based incentives of CEOs impact the propensity to commit fraud. While CEO behavior will respond exclusively to performance-based incentives, lower ranked executives (e.g., VPs) will respond both to performance-based incentives and to incentives stemming from the opportunity to get promoted to the CEO position and receive increased compensation, that is, promotion-based tournament incentives (e.g., Baker, Jensen and Murphy, 1988; Green and Stokey, 1983).

Rank-order tournaments are schemes of relative performance evaluation because the best relative performer wins and will receive the tournament prize. Tournament theory evolved as a way to explain the large pay gaps between the CEO and lower ranked executives commonly observed in practice and receiving considerable media attention. Lazear and Rosen (1981) have derived analytically that tournaments are optimal labor contracts, and they demonstrate a positive relationship between the effort made by agents and the magnitude of the tournament prize. Additionally, pay gaps provide a solution to the agency problems associated with monitoring difficulties that can prevent linking executive compensation to marginal product, such as, managerial shirking (Henderson and Fredrickson, 2001). Consistent with this finding, Kale, Reis, and Venkateswaran (2009) find that tournament incentives are positively

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associated with firm performance. This literature commonly proxies for tournament incentives (the promotion prize) using the pay gap between the CEO and lower ranked executives (VPs).

Cheng (2011) presents analytical and empirical evidence that schemes of relative performance evaluation can lead to financial misreporting, because executives try to manipulate the learning process about their abilities due to career concerns. Furthermore, Goel and Thakor (2008) show analytically that executives faced with tournament incentives tend to take on greater risks to increase their promotion probability. Greater risk-taking incentives may translate into more efficient operating and financial policies, but Armstrong et al. (2013) find that such incentives may also increase the incidence of financial misreporting activities.

Finally, experimental studies document that stronger tournament incentives lead to more sabotage (Harbring and Irlenbusch, 2011) and cheating, e.g., in the form of dishonest performance reporting (Conrads et al., 2014). Accordingly, this paper tests whether tournament incentives are positively associated with a propensity to engage in fraudulent behavior.

We investigate this question by using a sample of reported fraud cases in large U.S. companies between 1994 and 2004, as identified in Dyck, Morse, and Zingales (2010). In order to measure tournament incentives, we follow prior literature and use the pay gap between the CEO and the median VP. We expect to find larger pay gaps for fraud firms than for non-fraud firms.

We find that fraud firms, on average, have significantly larger pay gaps than non-fraud firms. Multivariate tests confirm our prediction of a positive association between tournament incentives and the propensity to engage in fraudulent behavior. Our results also suggest an economically meaningful effect of tournament incentives relative to other fraud determinants.

These results are robust to using different matching methods, including industry fixed effects (Erickson, Hanlon, and Maydew, 2006) and random effects (Lennox and Pittman, 2010). We also document the robustness of our findings to using alternative pay gap measures, controlling for VP ability and to the inclusion of variables related to corporate governance quality and CEO power (e.g., Bebchuk, Cremers, and Peyer, 2011; Chen et al., 2006). We further confirm the external validity of our findings based on the Dyck, Morse, and Zingales (2010) fraud sample by replicating a positive association between tournament incentives and the propensity to engage in fraud using firms named in SEC Accounting and Auditing Enforcement Releases (AAERs). To address the limitation that our primary measure of fraud captures the joint event of a firm engaging in fraud and being caught, we replicate our findings using the likelihood of misreporting as the dependent variable (Dechow et al., 2011).

Taken together, our results suggest that one potential drawback of providing tournament incentives is an increased propensity to engage in fraud. This finding contributes to the literature that investigates dysfunctional consequences as a response to increased incentives (Baker, 1992; Holmström and Milgrom, 1991; Jacob and Levitt, 2003). Specifically, our results align closely with other papers that find a positive association between tournament incentives and excessive risk-taking (e.g., Knoeber and Thurman, 1994), sabotage, and cheating behavior. Our results also complement recent evidence that the use of relative performance evaluation schemes (across firms) can encourage fraud (Wang and Winton, 2012). Our results suggest that tournament incentives significantly influence VP behavior as firms with larger tournament incentives are more likely to engage in fraudulent activities.

Our study also contributes to the literature that investigates the determinants of corporate fraud, and, more specifically, compensation. Most of that work has focused on performance-based incentives of the CEO and other executives (e.g., Armstrong et al., 2013). We document the importance of tournament incentives in explaining the observed variation in fraudulent behavior across firms omitted by prior literature.

Our findings are subject to four primary limitations. First, we caution against a causal interpretation of our findings. Although we aim to address omitted variables bias and results remain robust, e.g., via different forms of matching, random effects estimation and controlling for CEO compensation, CEO power, and corporate governance, ultimately, we cannot rule out that some unobservable variable is correlated with the pay gap and a propensity to engage in fraud.<sup>4</sup>

Second, we use the pay gap to proxy for tournament incentives. This is in line with labor economics (Bognanno, 2001) and other papers in the finance literature that study the effect of tournament incentives on performance (Kale, Reis, and Venkateswaran, 2009) and risk-taking (Kini and Williams, 2012). However, other papers have used variants of the measure to capture different phenomena such as CEO power (Bebchuk, Cremers, and Peyer, 2011) or CEO skill (Masulis and Zhang, 2012). Although we control for these alternative explanations, we cannot rule out that our proxy may suffer from measurement error.

Third, our results indicate that larger pay gaps are associated with dysfunctional consequences, but we provide no evidence of whether the benefits of tournament incentives, documented by previous studies (e.g., Faleye, Reis, and Venkateswaran, 2010; Kale, Reis, and Venkateswaran, 2009), outweigh the costs. Our results suggest considering both the benefits and costs of tournament incentives when designing compensation contracts.

Finally, our results primarily refer to a sample of detected fraud cases. These cases are a function of (i) conducting fraud and (ii) the probability of being detected. To the extent that the probability of being detected is correlated with the pay gap, this would alter our inferences. Our results using the probability of misreporting as the dependent variable, however, document that this alternative explanation is less likely.

The remainder of this paper is structured as follows. In section 2, we develop a testable hypothesis for the association between the likelihood of fraud and the CEO pay gap. Section 3 discusses our sample selection procedure and our research design, while section 4 reports our empirical results. In section 5, we conduct a number of robustness tests, and consider alternative explanations. Section 6 summarizes and concludes.

<sup>4</sup> For example, Bereskin, Campbell, and Kedia (2014) and Cumming, Leung, and Rui (forthcoming) show that corporate culture and board diversity may be associated with fraud.

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