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Tournament incentives and audit fees☆

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ABSTRACT

Prior studies suggest that promotion-based tournament incentives lead to greater managerial risk-taking and a higher propensity for financial misconduct and that auditors charge more for clients whom they perceive to have a higher likelihood of financial misreporting. Using a sample of US firms from 2000 to 2013, we hypothesize and find that tournament incentives are positively associated with audit fees. The association is attenuated for firms with a recent CEO turnover, in industries in which outside succession is more likely, and for family firms. The association is accentuated, however, when firms have large abnormal accruals or are experiencing poor performance and when the CEO nears retirement. This paper's findings advance our understanding of the links between corporate compensation policies and auditors' risk assessment and pricing decisions, as well as the economic consequences of promotion-based tournament incentives.

1. Introduction

Regulators and scholars are increasingly interested in the relationship between corporate compensation policies and auditors' pricing behavior (Wysocki, 2010). As the Public Company Accounting Oversight Board (PCAOB) (2012) noted in a release, "obtaining an understanding of how a company has structured its compensation for executive officers can assist the auditor in understanding whether such compensation arrangements affect the assessment of the risks of material misstatement" (PCAOB 2012; SAS No. 99, AICPA 2002; SAS No. 109, AICPA 2006).

Prior research on the relationship between executive compensation and audit pricing has predominantly focused on the CEO (e.g., Chen et al., 2015; Engel et al., 2010; Kim et al., 2015).[1] These studies examine performance-based incentives, such as stock options and bonus plans, which incentivize a CEO to work hard by tying her compensation to corporate performance. The general finding is that such incentives are associated with a higher likelihood of financial reporting irregularities (Duellman et al., 2013) and higher audit fees. However, these studies examine CEO pay in isolation and overlook the fact that a corporation is run by a top management team that includes other executives, such as vice presidents, who may also have personal incentives for misreporting and financial misconduct (Feng et al., 2011; Jiang et al., 2010). In fact, Karpoff et al. (2008a, 2008b) document that 1433 of 2206 culpable employees in fraud cases were VPs. Auditing standards therefore encourage auditors to obtain information for identifying and assessing the risk of material misstatement in the financial statements that is associated with a company's financial relationships and transactions with *all* of its executive officers, not just the CEO (PCAOB, 2012).

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[1] There is an emerging literature on the links between executive compensation and auditor compensation. Engel et al. (2010) document a positive relationship between audit committee compensation and auditor compensation. Wysocki (2010) presents descriptive empirical evidence suggesting economically large covariation in CEO compensation and audit fees. Kim et al. (2015) study CEO equity incentives and document a positive relationship between CEO equity portfolio vega and audit fees.

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In this paper, we are interested in VPs' incentives, particularly pay-gap–created promotion incentives, and how they affect auditors' risk assessment and pricing decisions. Unlike CEOs, who only face performance-based incentives, VPs also face a promotion-based incentive: the possibility of becoming CEO (Kale et al., 2009; Kini and Williams, 2012; Lazear and Rosen, 1981). Promotion to CEO is desirable as it is associated with higher pay, more privileges, and greater prestige (Murphy, 1999). Lazear and Rosen (1981) suggest that the larger the pay gap between the CEO and other executives, the larger the "prize" of winning the promotion, which in turn creates stronger tournament incentives among those other executives. Promotion-based tournaments are schemes of relative performance evaluation because the best relative performer will win and, in this case, become CEO, while the others will be "passed over" (Kini and Williams, 2012). Such tournaments may therefore be more consequential to managerial behavior than absolute levels of compensation (Bushman et al., 2016; Kale et al., 2009). Prior studies have shown that tournament incentives can lead to greater managerial risk-taking and higher propensity for financial misconduct (e.g., Haß et al., 2015; Kini and Williams, 2012). For example, 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. Haß et al. (2015) find consistent evidence that tournament incentives are associated with higher propensity for financial fraud.

In this study, we connect this line of research with another strand of literature that examines how auditors' pricing is affected by client firms' financial reporting quality. Audit fees are a function of the auditors' risk, which is determined by the client's financial condition and reporting quality (Simunic, 1980). Prior studies have shown that auditors charge higher fees for clients with lower reporting quality and a higher likelihood of financial misreporting (Bédard and Johnstone, 2004; Gul et al., 2003; Pratt and Stice, 1994).

Evidence from these two streams of literature is consistent with the notions that (a) tournament incentives encourage managerial risk-taking and financial misconduct and (b) auditors charge higher fees for clients with a higher likelihood of financial misreporting. These two links observed in prior research provide a basis for our main hypothesis that auditors will increase their assessments of audit risk and charge higher fees for firms with greater promotion-based tournament incentives.

We test this hypothesis by examining a sample of publicly traded US firms over the period 2000–2013. We measure tournament incentives in three ways. Our first measure is compensation differences between the CEO and the median-paid VP. As explained by Kini and Williams (2012), this measure serves as a proxy for a firm's tournament incentives by capturing the increase in the competing executive's compensation if she wins the promotion tournament. Because CFOs may play a more important role than other VPs in financial reporting, we construct a second measure of tournament incentive measures based on the pay gap between the CEO and the CFO. Our third measure is CEO pay slice, calculated as total CEO compensation divided by the sum of the total compensation of the five highest-paid executives in a given year. As a percentage rather than an absolute value, this measure is less affected by firm size, a major determinant of audit fees (Simunic, 1980).

Our main results suggest a positive and significant relationship between tournament incentives and audit fees. The economic effect is sizable: for example, when using CEO–median-VP pay gap as measure of tournament incentives, firms with pay gaps in the 75th percentile have audit fees that are, on average, 12 percent higher than those of firms with pay gaps in the 25th percentile. These findings are robust after controlling for client, auditor, and engagement attributes that prior studies have shown to affect audit fees.

One challenge in interpreting our main finding is that the association between tournament incentives and audit fees could be driven by unobservable characteristics related to both a firm's executive compensation contract design and to audit fees. In addition to using the lagged values of compensation-related variables (tournament and equity incentives) in the regressions, we also examine firm fixed effects and we construct instrumental variables for compensation-related variables and conduct a two-stage least squares (2SLS) analysis. These two analyses also suggest a significantly positive effect of tournament incentives on audit fees.

Next, we consider contingencies under which the observed relationship between tournament incentives and audit fees may be accentuated or weakened. The first contextual variable that we examine is abnormal accruals. We find that the relationship between tournament incentives and audit fees is stronger for firms with a greater amount of abnormal accruals. The next three contextual variables relate to the likelihood of CEO turnover. We find a weakened impact of tournament incentives on audit fees when the firm has experienced a recent CEO turnover. The relationship becomes stronger, however, when the CEO is close to retirement and for firms whose poor performance makes it likely that the CEO will be replaced.

Parrino (1997) suggests that outside succession is more frequent in homogenous industries because a manager's human capital is less firm-specific and more transferrable. We find supporting evidence that the relationship between tournament incentives and audit fees is weakened in industries with a higher likelihood of outside succession.

Finally, we examine whether the impact of tournament incentives on audit fees varies by firm type. We find that the relationship is significantly weakened for family firms.

Our study contributes to the auditing literature by advancing our understanding of the links between corporate compensation policies and auditors' pricing. One study closely related to ours is Bryan and Mason (2017), which also examines the relationship between tournament incentives and audit fees. However, our study differs from that one in several ways. First, although recognizing the potential endogeneity issue, Bryan and Mason (2017) did not conduct any test to address it. In contrast, we address this concern by using the 2SLS and firm fixed effects. Second, in addition to measuring tournament incentives as pay gaps between the CEO and median-paid VPs, or between the CEO and the CFO, we use another measure, CEO pay slice, which is not highly correlated with firm size and not examined in Bryan and Mason (2017). Third, we examine a broader range of contingent factors that may affect the relationship between tournament incentives and audit fees.

This study also contributes to the literature on the impact of tournament incentives on various corporate outcomes (e.g., Bebchuk et al., 2011; Chen et al., 2013; Kale et al., 2014; Kini and Williams, 2012). We provide evidence that tournament incentives also affect audit fees.