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Executive tournament incentives and audit fees

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ABSTRACT

This study investigates whether the incentives for non-CEO executives to become the next CEO, commonly known as "tournament incentives," influence auditor perceptions of risk. We argue that auditors are likely to view tournament incentives as affecting the risk of a material misstatement as well as the risk of litigation arising against the auditor, leading to an impact on audit fees. Using three alternative measures of tournament incentives from prior literature, we provide consistent evidence that stronger tournament incentives are associated with higher audit fees. We also find that the relation between tournament incentives and audit fees is moderated by insider CEO succession, CEO tenure, CEO age, auditor tenure, and abnormal accruals.

1. Introduction

Recent research suggests that CEO performance-based compensation affects auditor risk assessments (e.g., Chen, Gul, Veeraraghavan, & Zolotoy, 2015; Fargher, Jiang, & Yu, 2014; Kannan, Skantz, & Higgs, 2014; Kim, Li, & Li, 2015). In this study, we posit that the promotion-based compensation incentives of non-CEO executives impact the auditor as well. Specifically, our study investigates whether the incentives for non-CEO executives to become the next CEO, commonly known as "tournament incentives," influence auditor perceptions of risk.

The increase in compensation that a non-CEO executive would obtain from being promoted to CEO is a powerful incentive that motivates each executive to outperform rival executives in order to increase the likelihood of becoming the firm's next CEO (Haß, Müller, & Vergauwe, 2015; Kale, Reis, & Venkateswaran, 2009; Kini & Williams, 2012; Kubick & Masli, 2016; Lazear & Rosen, 1981; Prendergast, 1999). As the difference in compensation between the CEO and the other executives increases, the incentive to be promoted to CEO becomes stronger (Lazear & Rosen, 1981; Prendergast, 1999). This creates intense competition among non-CEO executives as each hopes to receive the increased compensation associated with "winning" the tournament.

Prior research suggests that executives respond to tournament incentives by putting forth greater effort, which leads to better firm performance (e.g., Kale et al., 2009; Lazear & Rosen, 1981; Prendergast, 1999). However, tournament incentives can have negative effects as well. For example, prior research finds that stronger tournament incentives are associated with greater performance misreporting (Conrads, Irlenbusch, Rilke, Schielke, & Walkowitz, 2014), more sabotage activities (Harbring & Irlenbusch, 2011), and a higher likelihood of fraud (Haß et al., 2015). Existing literature also suggests that stronger tournament incentives are associated with greater risk-taking (e.g., Andersson, Holm, Tyran, & Wengström, 2013; Goel & Thakor, 2008; Kini & Williams, 2012; Kubick & Masli, 2016), which can be detrimental to a firm if executives take excessive risks. In this study, we argue that auditors are likely to view tournament incentives as affecting the risk of a material misstatement as well as the risk of litigation arising against the auditor. Consequently, we expect tournament incentives to influence audit fees.

Consistent with prior literature (e.g., Haß et al., 2015; Kale et al., 2009; Kini & Williams, 2012; Kubick & Masli, 2016), we measure the strength of tournament incentives using the difference in compensation between the CEO and other executives. We utilize three measures: the natural logarithm of the difference between the CEO's total compensation and (1) the mean total compensation of the top five highest paid non-CEO executives, (2) the median total compensation of the top five highest paid non-CEO executives, and (3) the total compensation of the CFO. The results indicate that stronger tournament incentives are associated with higher audit fees, supporting our hypothesis. We also find that the relation between tournament incentives and audit fees is moderated by insider CEO succession, CEO tenure, CEO age, auditor tenure, and abnormal accruals.

This study makes several contributions. First, by showing that firms with stronger tournament incentives incur costlier audits, we add to the literature that identifies negative consequences associated with tournament incentives. Hence, when considering potential executive compensation structures, a costlier audit is one of several drawbacks that should be weighed against the benefits of having stronger tournament incentives. Second, we contribute to the emerging line of literature that investigates how executive compensation incentives affect auditor perceptions of risk. While prior research in this area examines

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performance-based compensation incentives, we extend this stream of research by considering the promotion-based compensation incentives of non-CEO executives. Lastly, Auditing Standard No. 12 was modified in 2014 to specify that auditors should consider executive compensation incentives when making risk assessments (PCAOB, 2010b). Regulators should be interested in our study because our results supplement prior research by providing further evidence that auditors take executive compensation incentives into account when assessing risk.

2. Hypothesis development

2.1. Tournament incentives

Tournament incentives create competition among non-CEO executives as each executive tries to outperform the others in order to increase the likelihood of being promoted to CEO (Haß et al., 2015; Kale et al., 2009; Kini & Williams, 2012; Kubick & Masli, 2016; Lazear & Rosen, 1981; Prendergast, 1999).[1] While this competition among executives leads to greater effort and better firm performance (Kale et al., 2009; Lazear & Rosen, 1981; Prendergast, 1999), it can also increase the risk of a material misstatement if executives resort to manipulating financial information. Recent research provides support for the idea that tournament incentives can potentially threaten the integrity of the financial reports. For example, Conrads et al. (2014) show that stronger tournament incentives are associated with greater dishonesty in performance reporting. Similarly, Haß et al. (2015) find that stronger tournament incentives are associated with an economically significant increase in the likelihood of fraud.

2.2. Audit fees

Audit risk is "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated" (PCAOB, 2010a), while auditor business risk is the auditor's exposure "to loss of or injury to his or her professional practice from litigation, adverse publicity, or other events arising in connection with financial statements audited and reported on" (AICPA, 2006). Prior research suggests that auditors respond to greater audit risk or auditor business risk by charging higher audit fees (e.g., Bedard & Johnstone, 2004; Bell, Landsman, & Shackelford, 2001; Greiner, Kohlbeck, & Smith, 2013; Gul, Chen, & Tsui, 2003; Lyon & Maher, 2005; Pratt & Stice, 1994; Schelleman & Knechel, 2010; Seetharaman, Gul, & Lynn, 2002; Simunic, 1980; Stanley, 2011).

2.3. Audit fees and tournament incentives

Executive tournament incentives are likely to affect auditor perceptions of audit risk and auditor business risk. Auditing standards specify that executive compensation incentives should be taken into account when assessing the risk of material misstatements and fraud (AICPA, 2002; PCAOB, 2010b). Prior research provides evidence that auditors consider performance-based executive compensation incentives when making risk assessments (e.g., Billings, Gao, & Jia, 2014; Chen et al., 2015; Fargher et al., 2014; Kannan et al., 2014; Kim et al., 2015); however, this line of literature does not examine whether promotion-based compensation incentives affect auditor perceptions of risk. Since non-CEO executives are often implicated in cases of financial misconduct (e.g., Feng, Ge, Luo, & Shevlin, 2011; Haß et al., 2015; Karpoff, Lee, & Martin, 2008a; Karpoff, Lee, & Martin, 2008b), auditors have reason to consider the promotion-based compensation incentives of non-CEO executives when making risk assessments. Therefore, based on the prior literature that suggests a positive association between tournament incentives and misreporting (Conrads et al., 2014; Haß et al., 2015), we expect auditors to perceive audit risk as higher when tournament incentives are stronger, implying higher audit fees.

In addition to audit risk, auditors also consider auditor business risk when making risk assessments (AICPA, 2006; Johnstone, 2000). An important component of auditor business risk is the risk of litigation against the auditor. When stakeholders incur losses, auditors are often the target of lawsuits because of their "deep pockets," and prior research finds that the risk of litigation against the auditor is higher when the financial condition of the client is weaker (e.g., Palmrose, 1987; Pratt & Stice, 1994; Stice, 1991; St. Pierre & Anderson, 1984). Thus, factors that tend to improve the financial condition of a firm lessen auditor business risk, while factors that threaten its financial condition increase auditor business risk.

On the one hand, there are reasons to believe that tournament incentives could decrease auditor business risk. For example, prior research suggests that stronger tournament incentives are associated with greater effort and better firm performance (e.g., Kale et al., 2009; Lazear & Rosen, 1981; Prendergast, 1999). This implies lower auditor business risk and lower audit fees. However, other evidence implies that tournament incentives could increase auditor business risk. For instance, existing literature suggests that stronger tournament incentives encourage greater risk-taking (e.g., Andersson et al., 2013; Goel & Thakor, 2008; Kini & Williams, 2012; Kubick & Masli, 2016), which can be harmful to a firm if executives undertake excessive risks. In addition, Harbring and Irlenbusch (2011) find that stronger tournament incentives increase sabotage activities, which also negatively impact the firm. These factors imply greater auditor business risk and higher audit fees. Therefore, as a result of these competing influences, whether tournament incentives increase or decrease auditor business risk is uncertain.

In summary, while we expect stronger tournament incentives to increase audit risk, there are reasons to believe that tournament incentives could either increase or decrease auditor business risk. In light of these competing factors, we do not make a directional prediction regarding the impact of tournament incentives on the auditor's assessed level of risk. However, since prior research finds that auditor perceptions of risk affect audit fees (e.g., Bedard & Johnstone, 2004; Bell et al., 2001; Greiner et al., 2013; Gul et al., 2003; Lyon & Maher, 2005; Pratt & Stice, 1994; Schelleman & Knechel, 2010; Seetharaman et al., 2002; Simunic, 1980; Stanley, 2011), we expect the net effect of these competing influences to be reflected in audit fees. Therefore, our hypothesis, stated in null form, is as follows.

H1: Tournament incentives are not associated with audit fees.

3. Methodology

3.1. Measures of tournament incentives and equity incentives

We use three measures of tournament incentives from the prior literature (e.g., Haß et al., 2015; Kale et al., 2009; Kini & Williams, 2012; Kubick & Masli, 2016). Each measure is based on the difference in compensation between the CEO and other executives, which captures the strength of tournament incentives because it reflects the compensation increase that an executive would realize if promoted to CEO. Our first two measures are calculated as follows: *MEANDIF* (*MEDDIF*) is the natural logarithm of the difference between the total compensation of the CEO and the mean (median) total compensation of the top five highest paid non-CEO executives (with total compensation measured by Execucomp variable TDC1). Our last measure, *CFODIF*, is the natural logarithm of the difference between the total compensation of the CEO and the total compensation of the CFO.

[1] As noted by Haß et al. (2015), the possibility of outsider succession does not affect the predictions of tournament theory. That is, as the difference in compensation between the CEO and other executives increases, an executive's desire to be promoted to CEO strengthens, regardless of the potential for outsider succession (Haß et al., 2015).

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