Advances in Accounting, incorporating Advances in International Accounting xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

Extreme CEO pay cuts and audit fees

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ARTICLE INFO

Article history:
Received 2 August 2015
Received in revised form 21 December 2015
Accepted 16 February 2016
Available online xxxx

Keywords:
Extreme CEO pay cuts
Audit fees
Audit risk

ABSTRACT

This study investigates whether sudden and severe reductions in total CEO compensation affect auditor perceptions of risk. We argue that extreme CEO pay cuts can incentivize the CEO to manipulate the financial reports or make risky operational decisions in a desperate attempt to improve firm performance. This incentive, in turn, is likely to impact auditor assessments of audit risk and auditor business risk, leading to higher audit fees. Consistent with our hypothesis, we find evidence of a positive and highly significant association between extreme CEO pay cuts and audit fees. The results suggest that audit fees are 4.6% higher when there is an extreme CEO pay cut, which corresponds to an audit fee that is $111,458 higher for the average firm-year observation in our sample.

1. Introduction

This study examines the impact of extreme reductions in total CEO compensation on auditor assessments of risk, as reflected in audit fees. Extreme CEO pay cuts, defined as reductions in total CEO compensation of at least 25%, are used to motivate the CEO to improve firm performance when the firm is struggling (Gao, Harford, & Li, 2012). However, we argue that severe reductions in CEO compensation provide an incentive for the CEO to manipulate the financial reports or to make risky operational decisions in an attempt to turn firm performance around. This incentive, in turn, can increase the auditor's assessment of risk and lead to higher audit fees.

Our study is related to the prior literature that examines whether executive compensation incentives affect (1) management's propensity to manipulate the financial statements and (2) auditor risk assessments. Prior research largely suggests that executive compensation incentives are associated with managerial manipulation of the financial reports (e.g., Bergstresser & Philippon, 2006; Efendi, Srivastava, & Swanson, 2007; Larcker, Richardson, & Tuna, 2007; Jayaraman & Milbourn, 2015); however, other research suggests that this association does not exist (e.g., Armstrong, Jagolinzer, & Larcker, 2010; Baber, Kang, & Liang, 2007). A related stream of literature examines whether executive compensation incentives affect auditor perceptions of risk, as revealed through audit fees. The results from this line of literature indicate that executive compensation incentives impact audit fees (e.g., Billings, Gao, & Jia, 2014; Chen, Gul, Veeraraghavan, & Zolotoy, 2015; Kannan, Skantz, & Higgs, 2014; Kim, Li, & Li, 2015).

Recent research has also started to examine sudden and severe decreases in total CEO compensation. Gao et al. (2012) suggest that extreme CEO pay cuts are used as a tool to motivate managers to exert effort to improve poor firm performance. However, Lobo, Manchiraju, and Sridharan (2013) find that although firm performance improves following an extreme CEO pay cut, much of the improvement is achieved via accruals and real activities manipulation, suggesting that extreme CEO pay cuts may not work as intended. Our study extends the line of literature that investigates whether executive compensation incentives affect auditor assessments of risk by examining whether extreme CEO pay cuts affect audit fees.

We argue that extreme CEO pay cuts are likely to influence auditor perceptions of risk. For example, when the CEO's compensation is severely reduced, or when the CEO anticipates that a severe compensation reduction is looming, the CEO has a strong incentive to report better firm performance as quickly as possible, which may increase the likelihood that the CEO will resort to manipulating the financial reports and, in turn, increase audit risk. In addition, the pressure to quickly improve firm performance may encourage the CEO to accept excessively risky projects with the hope that they yield abnormally high returns, which can increase the auditor's perception of auditor business risk. For these reasons, and based on the prior literature that documents a positive association between auditor perceptions of risk and audit fees (e.g., Bedard & Johnstone, 2004; Bell, Landsman, & Shackelford, 2001; Lyon & Maher, 2005; Schelleman & Knechel, 2010), we hypothesize a positive association between extreme CEO pay cuts and audit fees.

We test our hypothesis by utilizing a sample of 8352 firm-year observations from the period 2000–2011. Our results reveal a positive and highly significant association between extreme CEO pay cuts and audit fees, supporting our hypothesis. The results suggest that audit fees are 4.6% higher when there is an extreme CEO pay cut, which

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http://dx.doi.org/10.1016/j.adiac.2016.02.001
0882-6110/

corresponds to an audit fee that is $111,458 higher for the average firm-year observation in our sample. Our results are also robust to a variety of sensitivity tests.

Our study contributes to the growing stream of research that examines how executive compensation incentives affect auditor perceptions of risk. While prior findings suggest a positive association between audit fees and CEO compensation (e.g., Wysocki, 2010; Zhang & Xian, 2014), we find that abrupt decreases in CEO compensation are associated with higher audit fees for a subset of firms with extreme CEO pay cuts. We also add to the growing stream of research that examines extreme CEO pay cuts. In finding that auditors view extreme CEO pay cuts as increasing risk, our paper complements Lobo et al. (2013) by providing further evidence that extreme CEO pay cuts may have unintended consequences. Our paper should also be of interest to regulators because Auditing Standard No. 12, as amended in 2014, requires auditors to assess risks associated with the characteristics of executive compensation (PCAOB, 2010b). Our results add to the findings from prior research that suggest auditors do consider characteristics of executive compensation when making risk assessments.

The remainder of this paper is organized as follows. Section 2 reviews the relevant background literature and develops our hypothesis, Section 3 describes our methodology, Section 4 presents the results of the study, and Section 5 concludes.

2. Background literature and hypothesis development

2.1. Background literature

Prior research has posited that executive compensation incentives can encourage executives to manipulate the financial statements. For example, many papers find at least some evidence that executive compensation incentives are associated with managerial manipulation of the financial reports (e.g., Bergstresser & Philippon, 2006; Burns & Kedia, 2006; Cheng & Warfield, 2005; Denis, Hanouna, & Sarin, 2006; Efendi et al., 2007; Harris & Bromiley, 2007; Jayaraman & Milbourn, 2015; Johnson, Ryan, & Tian, 2009; Larcker et al., 2007; O'Connor, Priem, Coombs, & Gilley, 2006). However, a few studies fail to find evidence of an association (e.g., Armstrong et al., 2010; Baber et al., 2007; Erickson, Hanlon, & Maydew, 2006). Overall, this line of literature, though somewhat mixed, generally suggests that executive compensation incentives can encourage managers to manipulate the financial reports.

Another line of literature examines whether executive compensation incentives affect auditor perceptions of risk. Wysocki (2010) identifies five factors that would suggest a positive association between audit fees and executive compensation.[1] Subsequently, several studies have followed Wysocki (2010) by examining the association between audit fees and executive compensation and have found mixed results. Billings et al. (2014) find results consistent with CFO equity incentives being positively associated with audit fees; however, they do not find a consistent association between CEO equity compensation and audit fees. Billings et al. (2014) also find that CFO equity incentives have an even greater impact on audit fees for firms with ineffective internal control over financial reporting. On the other hand, Kim et al. (2015) suggest that CEO equity incentives are associated with audit fees, but CFO equity incentives are not. Specifically, the authors find that CEO vega is positively associated with audit fees, but find that CEO delta, CFO vega, and CFO delta are not associated with audit fees (Kim et al., 2015).

Kannan et al. (2014) find that both CEO and CFO vega incentives are positively associated with audit fees, but the authors find that CEO and CFO delta incentives are not associated with audit fees. Chen et al. (2015) document a positive association between CEO vega incentives and audit fees, but they find this relation is attenuated after the Sarbanes-Oxley Act of 2002. The authors also find that the positive association between CEO vega and audit fees is amplified for firms that face higher litigation risk (Chen et al., 2015). Although prior research finds that characteristics of a CEO's compensation structure affect audit fees, we are not aware of any paper that examines the influence of sudden and severe decreases in CEO compensation on audit fees.

A recent study by Gao et al. (2012) investigates extreme CEO pay cuts. Gao et al. (2012) argue that severe decreases in CEO compensation are used to motivate the CEO to improve firm performance during times when the firm is performing poorly.[2] The authors provide evidence suggesting that extreme CEO pay cuts and forced CEO turnover are substitutes and they argue that both of these alternatives provide the CEO with ex-ante incentives to exert effort to produce strong firm performance (Gao et al., 2012). Lobo et al. (2013) find results consistent with CEOs improving performance subsequent to extreme pay cuts; however, they find that much of the improvement is achieved via income-increasing discretionary accruals. Extreme CEO pay cuts represent sudden and substantial decreases in CEO compensation. For example, in our sample, the mean (median) reduction in total CEO compensation from the prior year when there is an extreme CEO pay cut amounts to approximately $2,831,000 ($1,469,000).

2.2. Hypothesis development

Extreme CEO pay cuts are likely to influence auditor perceptions of risk. Audit risk and auditor business risk are two types of risk that auditors consider. Auditing Standard No. 8 defines audit risk as "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated" (PCAOB, 2010a). Audit risk represents the risk that the auditor will fail to detect a material misstatement in the financial reports. Auditor business risk has been defined as 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). For example, a primary source of auditor business risk comes from the risk that the auditor could be subjected to litigation by being associated with a client that is financially distressed or otherwise risky. When faced with a higher degree of audit risk or auditor business risk, auditors are likely to respond by either putting forth additional audit effort or charging a fee premium to compensate them for the increased risk, either of which would lead to higher audit fees. Supporting this idea, prior research provides evidence that audit fees are higher when audit risk or auditor business risk is greater (e.g., Bedard & Johnstone, 2004; Bell et al., 2001; Gul, Chen, & Tsui, 2003; Greiner, Kohlbeck, & Smith, 2013; Lyon & Maher, 2005; Pratt & Stice, 1994; Schelleman & Knechel, 2010; Seetharaman, Gul, & Lynn, 2002; Simunic, 1980; Stanley, 2011).

Both prior research (e.g., Chen et al., 2015; Fargher, Jiang, & Yu, 2014; Kannan et al., 2014; Kim et al., 2015) and auditing standards suggest that auditors incorporate incentives related to CEO compensation into their assessments of risk. In fact, Auditing Standard No. 12, as amended in 2014, requires the auditor to obtain an understanding of executive compensation plans for purposes of "identifying and assessing risks of material misstatement of the financial statements" (PCAOB, 2010b). We expect that when an auditor observes that there has been an extreme CEO pay cut during the year, the auditor is likely to view audit risk and auditor business risk as being greater.

When the CEO's compensation is severely reduced, or when the CEO expects that a large compensation reduction is imminent, the CEO has a strong incentive to report improved firm performance as quickly as possible. This incentive may increase the likelihood that the CEO will manipulate the financial reports in order to meet performance expectations, which can increase the auditor's perception of audit risk.

[1] These factors are complexity, risk, strict governance, managerial entrenchment, and empire building (Wysocki, 2010).

[2] These decreases in CEO compensation are primarily accomplished by the firm reducing the quantity of stock and option grants it awards to the CEO (Gao et al., 2012).