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The Effect of Tournament Incentives on Financial Restatements: Evidence From China

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ABSTRACT

In this study, we examine the association between tournament incentives and financial restatements in China. Prior research documents that tournament incentives have a positive impact on firm performance. However, an alternative view suggests that tournament incentives can also have detrimental effects on firm performance. Using a sample of Chinese listed companies for the years 2008–2015, we find that tournament incentives, in the form of large pay disparities, reduce the occurrence of both core and non-core financial restatements. This negative association is more pronounced for SOEs as compared to non-SOEs. We further document that the negative association between tournament incentives and financial restatements is related to CEO turnover, and is stronger if the successor CEO is recruited from within the organization. This research contributes to a better understanding of tournament incentives, as a corporate governance mechanism, in constraining the occurrence of financial restatements in a unique institutional setting where state ownership is pronounced.

1. Introduction

This paper examines the impact of tournament incentives on the occurrence of financial restatements in China. The separation of ownership and control gives rise to information asymmetries that managers may use to exploit outside individual shareholders (Berle & Means, 1991; Jensen & Meckling, 1976). To minimize such sub-optimal managerial actions, researchers have identified a number of pure market forces, such as product market competition (Alchian, 1950; Stigler, 1958), the market for corporate control (Manne, 1965), and labor market pressure (Fama, 1980). However, despite these market controls, there remains residual demand for additional governance measures, such as well-designed managerial compensation schemes: an explicit form of compensation. A substantial body of academic research has investigated the association between this form of compensation and firm performance in various countries (Aggarwal & Samwick, 2006; Baker, Jensen, & Murphy, 1988; Cheng & Firth, 2006; Conyon & He, 2011; Jensen & Murphy, 1990; Kaplan, 1994; Kato & Long, 2006; Mengistae & Colin Xu, 2004; Tang & Sun, 2014; Xin & Tan, 2009).

However, an implicit compensation scheme in the form of rank-order tournaments also exists (Lazear & Rosen, 1981; Lin & Lu, 2009). Tournament theory views executives as competitors contesting for promotion, and the large pay gap between the CEO and other executives becomes the prize for the tournament (Bognanno, 2001; Eriksson, 1999; Kale, Reis, & Venkateswaran, 2009; Lazear & Rosen, 1981). A large pay disparity motivates non-CEO senior executives to work hard and to invest in firm-specific human capital and, thus, helps build a motivated pool of internal candidates for the CEO position. Such a pool of internal candidates increases the bargaining power of the board, thus fostering positive CEO actions. Therefore, this perspective predicts a positive association between

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pay disparity and firm performance (Kale etal., 2009), and a negative association between pay disparity and the cost of capital (Chen, Huang, & Wei, 2013).

On the other hand, the managerial power perspective (Bebchuk & Fried, 2003) suggests that a large pay disparity reflects CEO power and the probability of a CEO becoming entrenched. An entrenched CEO is associated with a more severe agency problem during his/her tenure (Bebchuk, Cremers, & Peyer, 2011). Therefore, a negative association between tournament incentives and firm performance has also been documented (Bebchuk etal., 2011; Henderson & Fredrickson, 2001). Tournament incentives also create incentives for senior managers to engage in earnings manipulation (Park, 2017) and, in extreme cases, in fraud (Haß, Müller, & Vergauwe, 2015). We argue that tournament incentives can have a constraining effect on managerial incentives for earnings manipulation that may have implications for subsequent financial restatements.

A restatement represents an acknowledgement by the firm of a material omission or misstatement in their financial statements (Palmrose & Scholz, 2004). Firms restating financial statements have suffered substantial losses in market values (Karpoff, Lee, & Martin, 2008; Palmrose, Richardson, & Scholz, 2004), increases in the cost of capital (Hribar & Jenkins, 2004), and high executive turnover (Hennes, Leone, & Miller, 2008; Srinivasan, 2005). Restatements call into question the credibility of future financial reports, because of a given firm's previously released low-quality financial information. Effective corporate governance has been argued to be a constraining factor for restatements, but the empirical evidence is far from conclusive (Agrawal & Chadha, 2005; Almer, Gramling, & Kaplan, 2008; Romanus, Maher, & Fleming, 2008). However, the association between tournament incentives, as a corporate governance mechanism, and financial restatements remains unexplored.

Financial restatements affect the likelihood of managerial promotion negatively. In the event of restatements, the probability of promotion for VPs will be low, since the shareholders as well as the investors will be skeptical about their capacity to maximize shareholder value (Kini & Williams, 2012). Moreover, drawing on the Neo-institutionalism in organizational theory, financial restatements could damage the company's legitimacy. Dismissal of the CEO is a commonly used tool for repairing and restoring damaged legitimacy (Arthaud-Day, Certo, Dalton, & Dalton, 2006). As a result, managers will be discouraged from taking actions that might subsequently cause restatements, if they believe that winning the tournament will give them a much higher return.

We test this association using data from China. As China is a growing economic power with high levels of government ownership, its corporate governance has often been criticized as ineffective and weak (Clarke, 2003; Lin & Lu, 2009; Liu, 2006). Executive compensation is a key internal mechanism that may lead to good corporate governance. A few studies have provided empirical evidence for a positive relationship between firm performance and compensation in Chinese listed companies, and for this relationship to be moderated by the level of government ownership (Chen, Ezzamel, & Cai, 2011; Kato & Long, 2006, 2011; Lin & Lu, 2009).

In the Chinese capital market, > 50% of Chinese listed companies are state-owned(Hass, Tarsalewska, & Zhan, 2016). The pronounced state influence over listed companies through their shareholding (i.e.,publicly listed SOEs) has important implications for the study of tournament incentives (Hass etal., 2016). Because of the pronounced state influence in the listed SOEs, the compensation gap in Chinese companies is also strongly influenced by the external political and regulatory environment (Conyon & He, 2011; Firth, Fung, & Rui, 2006a; Lin & Lu, 2009).

The 2014 “pay cap” policy enforced by the State-owned Assets Supervision and Administration Commission (SASAC) is intended to narrow the pay differences between the average compensation of executives and the average salary of the employees of SOEs from a ratio of 12:1 to a ratio of 7:1 or 8:1 (State Council, 2014). The executive compensation structure of Chinese listed SOEs has been criticized for being insensitive to firm performance, since their pay is primarily linked to political power. The political promotions within the government hierarchy are often accompanied by life-long benefits in the Chinese listed SOEs, including substantial housing subsidies, high levels of pension, fully subsidized medical treatment, and job security (Chen etal., 2011; Kato & Long, 2006). Prior literature documents evidence that the positive effect of tournament incentives on firm performance is dampened in the Chinese listed SOEs, owing to a high level of state ownership and the aforementioned executive compensation schemes (Chen etal., 2011; Kato & Long, 2011; Lin & Lu, 2009). Our study on the role of tournament incentives in constraining financial restatements for SOEs versus non-SOEs may have implications for “pay cap” policy. Moreover, the Chinese authorities have encouraged convergences with the International Financial Reporting Standards (IFRSs), including accounting standards related to executive compensation.[1] An investigation of the constraining effect of tournament incentives on the occurrence of financial restatements under the new Chinese accounting standards (2007 ASBEs)[2] would enrich the existing corporate governance literature in emerging economies.

We find that tournament incentives in the form of large pay disparities reduce the occurrence of financial restatements. We also consider the types of financial restatement: core restatements (related to balance sheet, income statement, and so forth) and non-core restatements (not related to financial statements). The reported results reveal that tournament incentives reduce the occurrence of both core as well as non-core restatements. We then test the association between tournament incentives and financial restatements for both SOEs and non-SOEs. The negative association is found to be stronger for SOEs than for their non-SOE counterparts. Given that tournament incentives have been found in prior research to be weaker for SOEs (e.g.,Chen etal., 2011; Kato & Long, 2011), this negative association is counterintuitive. One possible explanation may be the fact that executives in the listed SOEs might pursue non-cash incentives, such as political promotion, instead of cash incentives. Such political promotion often comes with very attractive life-long benefits (Chen etal., 2011; Kato & Long, 2006). The size of the tournament reflects the executives' administrative position in the

[1] The Accounting Standards for Business Enterprises (ASBEs) which took effect from 1 January 2007 (2007 ASBEs) are mandatory for listed companies and cover nearly all of the topics under the current IFRSs. ASBE11 share-based payment converges with IFRS 2 in principle, although some differences still exist in the scope, measurement, and disclosure (Deloitte China, 2006).

[2] The ex-Chairman of IASB, Sir David Tweedie, said that “the adoption of the new Chinese accounting standards system bring about substantial convergence between Chinese standards and IFRSs, as set by the IASB” (Deloitte China, 2006, p.2).