DISCUSSION: COUNTERPARTY RESPONSES TO MANAGERIAL OVERCONFIDENCE

20th Illinois Audit Symposium
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Summary

• Role of CEOs’ over confidence in the decisions of auditors and bond raters
  – Audit fees charged
  – Credit rating assigned

• Counterparties take the over confidence of the CEO into account
  – Charge higher audit fees and assign lower credit ratings
    • After controlling for determinants of audit fees and ratings
## What is Over Confidence?

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<th>Research Area</th>
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<td>Delayed Option Exercise Press Portrayal</td>
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<td>Hribar &amp; Yang (2011)</td>
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<td>Compensation (Log Salary &amp; Bonus), Founder, Tenure, Expertise (Education, CPA, Auditor), Age and Gender</td>
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<td>Sunder, Sunder &amp; Tan (2010)</td>
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What is Over Confidence?

• Is over confidence on the part of the CEO the same as risk taking?
  – Does it matter to the counterparties studied in this paper?

• Is the relationship linear throughout the distribution of confidence?
  – What about the “under confident CEO”?
    • These are relative degrees of confidence
  – Is there a difference between “extreme” over confidence and regular over confidence?
    • Narcissistic CEOs (Chatterjee & Hambrick, 2007, 2011)?
What is Over Confidence?

• Can we separate over confidence in the mean from over confidence about the variance?
  – Does the source of the variance matter to the two counter parties studied?
  – Are outcomes different from mean versus variance over confidence?
Over Confidence and Auditors

- Ultimately, auditors assess risk. If more confident CEOs make riskier decisions than less confident CEOs, all else equal, I would expect the auditor to consider this risk in determining fees.
  - Schrand & Zechman (2012) find that over confident CEOs are more likely to engage in financial misstatements
  - Auditing Standard No. 5 emphasizes tone from the top

- Period of the study encompasses several major changes for the auditing profession
  - Introduction of Sarbanes Oxley Act 2002
  - Auditing Standard No. 2 introduced 2004
  - Auditing Standard No. 5 introduced 2007
    - Likely outside the current time period studied

- What role did these changes play in the pricing of audits?
  - Is the premium constant for over confidence throughout the period of regulatory change?
Over Confidence and Credit Rating Agencies

- What does a credit rating actually mean?

\[ \text{Probability of Default} \times \text{Loss Given Default} \]

- So if over confidence plays a role it must change one of these.
  - Will the role be equal across all parts of the distribution of credit ratings?
    - Will over-confidence play the same role for AAA as for B?
  - What mechanism enforces the credit rating agencies to consider over-confidence?
    - During the period studied credit rating agencies were not sued for “getting it wrong”
      - Protected free speech under the first amendment
    - Especially for firms far from default
Research Design

- Over confidence as portrayed in the press (Malmendier and Tate, 2008)
  - Gets around potential endogeneity issues
    - Does depiction in the press alter the subsequent behavior?
    - What impact does the firm have on press coverage?
  - This setting measures the variable contemporaneously with the either audit fee or credit rating

- Are there trends through time with the optimism in the press?
  - Less optimistic in recessionary periods more optimistic in expansionary periods.
Research Design

• **Does the auditor ever change in the sample?**
  – How do you deal with the demise of Arthur Andersen?
• **What causes the CEO to change?**
• **Does the credit rating ever change?**
  – What causes the rating to change?
How do equity holders perceive over confident CEOs? Is this a diversifiable risk?

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<tr>
<td>CONF_CON</td>
<td>-0.04</td>
<td>0.05</td>
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<tr>
<td>CONF_DIS</td>
<td>-0.06</td>
<td>0.01</td>
</tr>
<tr>
<td>FACTOR</td>
<td>0.07</td>
<td>-0.01</td>
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Data and Results

- Perhaps change the proxy for litigation risk
  - Negatively correlated with LNAUDFEES
  - Kim and Skinner might be a better measure
- In changes model, does $\Delta$CONF_DIS act as a noisy proxy for change in the CEO rather than any change in confidence?
  - Only significant variable in Table 4
- Investment Grade versus Speculative grade indicator variable doesn’t capture the underlying nature of the distribution
Data and Results

• Economic significance of over confidence
  – Seems huge for audit fee results
    • Especially after all the other controls
  – How frequently would over confident CEOs have a lower rating?
    • Does it change the yield, either on a bond issue or a secondary trade?