DO CEOs MANAGE EARNINGS BEFORE TURNOVER AND DO AUDITORS RECOGNIZE THE RISK?

By

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I. INTRODUCTION

CEOs have a large amount of control within an organization and discretion when it comes to accounting within a firm. A firm’s earnings also have large implications both internally and externally. Internally the earnings of a firm affect executives and lower level employee’s compensation, when a portion is based on earnings. Externally, investors and the market take into account the earnings of a firm and the smoothness of the earnings when considering whether or not to invest and the future of the company. The CEO in charge of large firms are not solely responsible for the financial statements, but in many cases they have the final say in discretionary expenses such are research and development and advertising, which can be income increasing accruals that increase earnings.

CEOs’ leave firms for a variety of reasons, the two biggest are for retirement or a different opportunity within another firm. I would like to see if there is earnings management involved prior to a CEOs departure and to what extent the earnings management vary between CEOs leaving for retirement or a different job. An additional analysis I will perform is looking at auditors and whether they are able to recognize the risk associated with a CEO during their terminal years.

Within the research on retirement of CEOs, there is horizon problem that effects the CEOs performance in their final years. The horizon problem has been heavily researched and clearly has an effect on CEOs leaving a firm. There is a lack of research on CEOs leaving a firm and moving to a new job and whether or not these CEOs manage earnings to make their image positive and increase the earnings of the company. I look to see if like CEOs who are retiring, CEOs who are leaving a firm for a new job also use discretionary accruals to increase income to manage earnings prior to their departure.
I also look to see if auditors are recognizing the risk associated with a departing CEO. If discretionary accruals are higher when a CEO leaves a firm either for retirement or a new job, there is increased risk of earnings management and therefore a possible restatement of the financial statements in the future. I will see if auditors are recognizing this risk and are scrutinizing the financial statements more than they would have if the CEO were remaining at the firm. The increase risk would be an increase in the audit fees charged by the audit firm. There is a gap in the literature when looking at voluntary turnover of a CEO and the audit fees. There is no difference in the audit fees for voluntary turnover. However, when a CEO is retiring it may be voluntary, but they have also had time to know when they will be leaving and how long they have to manage earnings upward.

Top executives within firms should be interested in this study, because if they know that there is increased risk of earnings management in a CEOs terminal years, they may be more willing to prevent discretionary accruals that do not reflect the firm. In addition, they may increase their controls to prevent earnings management by the CEO in their final years. This will help the long-term growth and future of the company. Also, auditors would be interested in this study, because it will be able to show that there may be irregularities in the earnings of a company where the CEO is in their terminal year and there will be an increased risk for the audit firm. The audit firm has the opportunity to charge a premium for the uncertainty going in to the audit. This will help the audit firm in the future, if any litigation arises from restatements due to the earnings management performed by the CEO. Opportunities for future research could include looking at other executives like the CFO. Another extension of this study would be to see if discretionary accruals differ between a female CEO versus a male CEO.

II. THEORY AND HYPOTHESES
In prior literature, such as Smith and Watts 1982; Dechow and Sloan 1991; Cheng 2004, they have found a horizon problem in departing CEOs. The horizon problem in this case comes from CEOs who are leaving a firm and have little incentive to improve the firm or motivation to make decisions that are not in the best interest of the firm in their final years (Dechow and Sloan 1991). CEOs are willing to jeopardize the long-term health of the firm, in order to improve their image and reputation prior to their departure. The horizon problem is greater when the CEO plans to retire versus moving to a new firm (Gibbons and Murphy 1992). The Gibbons and Murphy paper examines how executive compensation affects a CEOs investment decisions. Investment policies and compensation contracts within firms are focused on short-term returns and incentivize CEOs to make decisions that are beneficial in the short run, but detrimental in the end.

Compensation also affects a CEOs decision to manipulate earnings. A retiring CEO whose retirement bonus is based on the year’s earnings of the firm is more likely to manipulate earnings to record higher earnings in the retirement year than years prior. The income increasing accruals reverse in future years and by recording higher income in a CEOs final year they will most likely not be present when the accruals reverse. According to Healy, earnings-based bonus plans affect managerial decision-making and create incentives for executives to manipulate earnings across years. Bonus pools have floors and ceilings and if the current earnings are lower than the year’s bonus level, executives will delay recording earnings until the next year to have “excess” earnings the following year. This study shows that managers knowingly act to increase their earnings-based bonuses.

When CEOs retire, they would rather improve their own image over the long-term growth and health of the company. A retiring CEO has fewer repercussions than a CEO that is
leaving a firm to join a new firm (Kalyta). Empirical evidence on the association between CEO retirement and their managerial accounting discretion is mixed and most studies have been inconclusive with support of the association (e.g., Murphy and Zimmerman 1993; Pourciau 1993; Wells 2002; Cheng 2004). However, when a CEO’s compensation when retiring depends on the firm’s performance, income increasing earnings management is present (Kalyta 2009). CEOs may undertake various projects that may not be in the best interest of the firm and increase discretionary expenditures in their final years at a firm. Gibbons and Murphy (1992) found that in CEOs final years they are more likely to accept projects that have a negative net present value and increase research and development and marketing expenses. The CEOs are leaving the firm and have few repercussions in the future if it negatively affects the firm once they have left.

CEOs are more likely to manage earnings in their early years and final years of their tenure. In a CEOs early years, they have to prove their ability due to the markets uncertainty of their ability and they have a greater incentive to overstate earnings. When earnings overstatements in the early years of service are controlled and then compared to the final year of service, earnings overstatements are higher in a CEOs final year. Through the internal controls during a CEOs tenure overstatements through earnings management are reduced due to the high probability that the CEOs motivations will be detected (Ali and Zhang 2004). This study does not reflect why the CEO leaves a firm, but it does assume that if a CEO leaves after only a few years of service the CEO might have been terminated by management.

CEOs are motivated to make themselves look better on their way out in order to increase their compensation and image. Overstatements in a CEOs final years are significantly greater than other years during their tenure. These discretionary overstatements will eventually reverse, and when they do the old CEO will be gone and the new CEO will be tasked with improving the
outlook of the company. Retiring CEOs are concerned with short-term returns and are willing to jeopardize long-term success for short-term profits, because they face fewer repercussions than CEOs leaving for a new job. Graham et al. conducted a field study of over 400 executives and 78% of the sample admits to sacrificing long-term value to smooth earnings. Executives believe that earnings are the key metric that investors and outsiders value versus cash flows. Therefore, retiring CEOs are more likely to increase their earnings through accruals to make the company look more profitable. Retiring CEOs also usually know a specific time or time range when they will retire, which gives them time to improve earnings before their tenure ends. CEOs who leave a firm unexpectedly leave and therefore do not have the advantage of improving their earnings before they move on to a new firm.

In my secondary analysis, I will be looking at whether or not auditors recognize the risk of a CEO in their terminal years. CEOs that are planning to retire know when they will step down from their job, thus giving them a period to manage earnings and report higher earnings. I would like to see if auditors recognize the risk and whether or not they in return increase audit fees to reflect an increase in effort and risk of litigation. When compared to forced dismissal of a CEO, audit fees are lower for voluntary turnover of a CEO (Huang et al. 2014). The audit fees incurred by a firm with voluntary turnover are no different when compared to the fee when no turnover is present. Auditors do not expect an increase risk when a CEO voluntary leaves a firm. Auditors are not recognizing the risk imposed by a retiring CEO that has an incentive to manage earnings and create more work for the auditors to test and increase of work that would likely incur a higher fee. If CEOs do in fact increase discretionary accruals prior to their departure, audit firms have an incentive to charge higher fees due to effort and risk.
Auditors should definitely be interested in this study, because it will show that they will need to exert extra effort to insure the financial statements are reliable and reflect the client’s financial outlook. This also gives audit firms the opportunity to gain a premium from firms with a retiring CEO and potentially a CEO that is leaving for another position. In addition, CFOs and other executives that are knowledgeable about the financial statements of a firm should be interested. These executives may be able to recognize earnings management techniques that the CEO is trying to use and help reverse the CEOs effort to manage earnings. Other executives will continue their tenure after the CEO has left, and would care about the firm’s financial position and smooth earnings from year to year.

**H1a:** Discretionary accruals will be higher for a CEO that is leaving a firm for retirement.

**H1b:** Discretionary accruals will not change for a CEO that is leaving a firm for a new job.

For my first hypothesis, I expect that discretionary accruals will increase the year prior to a CEOs departure for retirement, but will not change if the CEO leaves for a new job. I expect that discretionary accruals will increase the year before CEO turnover due to retirement; therefore, I think there will be a positive relationship between discretionary accruals and CEO turnover. This positive relationship can be explained by the horizon problem for CEOs retiring, but for CEOs leaving to work at a new firm there may be no effect on discretionary accruals. In some companies, retiring CEOs are compensated for their earnings during their terminal year, while some are not. Earnings based compensation should be controlled for in the first hypothesis, because firms where a retiring CEOs compensation is based on the firm’s earnings may be more likely to manage earnings more than a CEO who is just trying to improve their final image. When CEOs are retiring they are able to know when they will retire and prior to their departure they can manage earnings to make the company and themselves look better. I expect that there
won’t be a difference in the discretionary accruals when a CEO leaves for a new job. They do not have a set timeline in which they know when to start managing earnings in order to increase the firm’s earnings prior to their departure.

**H2a**: As tenure with a firm increases, the discretionary accruals also increase when a CEO leaves a firm for retirement.

For my second hypothesis, I expect that tenure to a firm may affect earnings management. As a CEOs tenure lengthens, they may be more likely to manage earnings, therefore increasing discretionary accruals. As tenure of CEO increases, they become more powerful and more likely to pursue their own interests rather than their stockholders (Hill and Phan 1991). As a CEOs tenure grows, they develop more trust from the board and appoint more and more board members. This will allow them more discretion within the accounting of the firm and the board and other executives will be less likely to question any discretionary accruals. Tenure is a moderator in this hypothesis that is expected to increase earnings management through discretionary accruals prior to a CEOs retirement. As a CEOs tenure lengthens, the board and other executives develop more trust, let down their guard and controls, and are less likely to suspect that the CEO will be likely to manage earnings.

**H2b**: As tenure with a firm increases, discretionary accruals will also increase when a CEO leaves a firm for a new job.

I expect the discretionary accruals of a CEO leaving a firm for a new job to have the same moderating effect from tenure. The length of a CEOs tenure may be the same whether they are leaving for retirement or a new job. If tenure ends up decreasing the amount of discretionary accruals I think that the longer a CEO is with a firm, the more devoted they are to increase actual
cash flow and earnings, rather than increasing discretionary accruals that will eventually reverse in future years.

*H3: Audit fees will not change in the year a CEO departs a firm either for retirement or a new job.*

For my third hypothesis, I inspect whether audit firms recognize the risk of increased earnings management prior to CEO retirement. Auditors modify the audit risk model in response to increasing risk in the client’s financial statements and business risk. If a company has strong internal controls and has strong financial statements from year to year, an audit firm would not recognize the risk when the CEO is retiring, because they may think that the existing controls would control any earnings management that may be present (Houston et al. 1999). There may be no change in the audit fees when a CEO retires, because of strong controls and low likelihood that a CEO would be able to manage earnings to the extent that the financial statements would be at the risk for restatement in the future. In a prior study it was shown that audit fees did not increase due to voluntary turnover (Huang et al. 2014). As such, for my third hypothesis, I think audit fees will not increase in the year a CEO retires or voluntarily moves to a new job. This is because firms have internal controls in place to prevent management of earnings and would keep the audit work to a minimum.

I expect that the audit fees charged by audit firms will increase in the year prior to a CEOs turnover due to the increase in discretionary accruals. An audit firm may not know that it is the year prior to the CEOs retirement, if it is not one of the company’s policies. If a CEO is close to retirement age, but not open about retiring to the board, the auditors may not increase effort due to a possibility of earnings management prior to the CEOs departure. Some large companies have policies that executives must retire by the age of 65 and auditors will know when this will
be since they know the birthdate of the CEO. At other companies a CEO may know when they plan to retire, but not reveal their intentions to the firm until they actually retire. This hypothesis will show that auditors are recognizing increased risk when there are higher discretionary accruals and effort of an audit of the firm will have higher risk and require more effort and time. Also, if the company has strong internal controls in place, discretionary accruals may be lower and therefore there may be no change in the audit fees, showing that auditors do not believe there is any increased risk present.

Assuming I find all the results I hypothesized there could be other explanations to the results. Discretionary accruals can increase for a variety of reasons and a few decisions by the CEO may have an effect. Top executives in addition to the CEO can increase discretionary expenses that can make the discretionary accruals look abnormally high and suspect that the CEO may be managing earnings. In addition, there may be tension in the measurement of turnover. CEOs are motivated to look better in their terminal years, even if they are moving on to a new job. They would like the best image and reputation possible to help with incentive contracts and compensation within their new firm. CEOs may also increase their discretionary accruals to increase earnings in their terminal years not only to make themselves look better, but also to increase their compensation. It may be difficult to see in the first hypothesis, which has a greater effect on discretionary accruals, retirement versus moving to a new job.

III. METHOD

In my research, I will find results for each of my hypotheses using the Compustat and Execucomp databases. The variables I examine are earnings management and CEO turnover. Earnings management will be operationalized through discretionary accruals, which is the difference between total accruals and normal accruals, the Modified Jones model (Dechow et al.
1995). The independent variable of turnover will be measured as a binary variable where “1” will reflect the old CEO is present and “0” when the CEO leaves for either retirement or another job. I will also use a variety of controls that have been used in prior literature.

To find the data I measure the discretionary accruals of CEOs in their terminal years. I will look at the years of 1995-2015 and within those years, I will select firms that had a CEO turnover. I will use Execucomp to see if the CEO leaves the firm and if they moved to another firm. I chose to look at 20 years, because the average CEO tenure is about 8.1 years (Ali and Zhang 2015). This time period will be able to show when the CEO took office and eventually left office. It will allow me to see if there is a difference in discretionary accruals in the year prior to their departure. It will also allow me to see if the audit fee increases when the CEO is leaving and decreases when the new CEO takes office.

As mentioned above, I will use the Modified Jones model (Dechow et al., 1995) to operationalize earnings management:

\[ \text{Acc}_t = \alpha + \beta_1 (\Delta \text{Rev}_t - \Delta \text{Rec}_t) + \beta_2 \text{PPE}_t + \epsilon_t \]

The modified Jones model excludes the growth of credit sales to increase the power when revenue is manipulated. Abnormal accruals have positive persistence and require more estimation than non-discretionary accruals and therefore leads to less persistent earnings. The equation measures the normal level of accruals and the residuals are considered the “abnormal” accruals.

As such, in the first hypothesis there are two models. In the first model the discretionary accruals will be measured for firms where the CEO retired. The discretionary accruals will be measured for 20 consecutive years. The turnover variable will be measured as a binary variable,
where 1 will be when the old CEO is in office and 0 when the CEO leaves. In the second equation, the discretionary accruals will be measured for CEOs that left the firm for a new job. Again the turnover variable will again be binary, where 1 will be for the years when the CEO is still in office and 0 in the year when the CEO leaves the firm. I will then compare the discretionary accruals of the two models versus a firm that had no turnover. I will be able to see if when a CEO leaves a company there is earnings management involved. I think in the first hypothesis will be positive due to a higher amount of earnings management due to retirement versus a new job.

(1) \[ \text{DiscretionaryAccruals}_{t-1} = \beta_0 + \beta_1 \text{turnover(retire)}_t + \beta_2 \text{LnMVEquity}_t + \beta_3 \text{MarketBookRatio}_t + \beta_4 \text{LitigationRisk}_t + \beta_5 \text{Leverage}_t + \beta_6 \text{InstitutionalOwnership}_t + \beta_7 \text{Merger&Acquisition}_t + \beta_8 \text{Issuer}_t + \beta_9 \text{ROA}_t + \beta_{10} \text{Loss}_t + \beta_{11} \text{CFO}_t + \beta_{12} \text{LaggedAccruals}_t + \beta_{13} \text{LaggedNoa}_t + \beta_{14} \text{TotalAssetGrowth}_t + \beta_{15} \text{EmploymentGrowth}_t + \varepsilon \]

(2) \[ \text{DiscretionaryAccruals}_{t-1} = \beta_0 + \beta_1 \text{turnover(new job)}_t + \beta_2 \text{LnMVEquity}_t + \beta_3 \text{MarketBookRatio}_t + \beta_4 \text{LitigationRisk}_t + \beta_5 \text{Leverage}_t + \beta_6 \text{InstitutionalOwnership}_t + \beta_7 \text{Merger&Acquisition}_t + \beta_8 \text{Issuer}_t + \beta_9 \text{ROA}_t + \beta_{10} \text{Loss}_t + \beta_{11} \text{CFO}_t + \beta_{12} \text{LaggedAccruals}_t + \beta_{13} \text{LaggedNoa}_t + \beta_{14} \text{TotalAssetGrowth}_t + \beta_{15} \text{EmploymentGrowth}_t + \varepsilon \]

My control variables include:

\[ \text{LnMVEquity} = \log \text{of the market value of equity at the beginning of the year } t \]
\[ \text{MarketBookRatio} = \text{the market value of equity divided by the book value of equity at the beginning of year } t \]
\[ \text{LitigationRisk} = \text{a binary variable that equals 1 if the firm operates in a high-litigation industry, and 0 otherwise} \]
\[ \text{Leverage} = \text{the total debt divided by total assets at the beginning of year } t \]
\[ \text{InstitutionalOwnership} = \text{the percentage of stocks held by institutional investors at the beginning of year } t \]
\[ \text{Merger&Acquisition} = \text{a binary variable that equals 1 if the firm has engaged in a merger and acquisition in year } t, \text{and 0 otherwise} \]
Issuer = a binary variable that equals 1 if Merger&Acquisition is not equal to 1 and if the number of outstanding shares increased by at least 10% or long-term debts increased by at least 20%, or the firm first appears on the CRSP monthly returns database in year t, and 0 otherwise

ROA = earnings before extraordinary items in year t divided by total assets at the beginning of the year t

Loss = a binary variable that equals one if the firm reports a net loss for year t, and 0 otherwise

CFO = cash flow from operations in year t scaled by total assets at the beginning of year t

LaggedNOA = net operating asset at the beginning of year t, defined as shareholders’ equity less cash and marketable securities, plus total debt, deflated by sales

LaggedAccruals = total accruals in year t – 1 scaled by total assets at the beginning of the year

TotalAssetGrowth = the change of total asset during year t scaled by the total asset at the beginning of year t

EmploymentGrowth = the change of employment during year t scaled by the employment at the beginning of year t

In my second hypothesis, I expect that loyalty will be a moderator of discretionary accruals. I think by including loyalty I will be able to see if loyalty actually affects a CEOs managing of earnings. I will measure loyalty as CEO tenure, which is the length of time a CEO has been in office. I will use tenure, because I think that as a CEOs tenure increases within a firm they will care more about the earnings due to their compensation and image. I will use the following models to separately test CEO’s that are retiring (eqn. 3) and those that are moving to a new job (eqn. 4):

$$\text{(3) DiscretionaryAccruals}_{t-1} = \beta_0 + \beta_1 \text{turnover(retirement)}_t + \beta_2 \text{tenure} + \beta_3 \text{turnover(retirement)}_t \times \text{tenure} + \beta_4 \text{LnMVEquity}_t + \beta_5 \text{MarketBookRatio}_t + \beta_6 \text{LitigationRisk}_t + \beta_7 \text{Leverage}_t + \beta_8 \text{InstitutionalOwnership}_t + \beta_9 \text{Merger&Acquisition}_t + \beta_{10} \text{Issuer}_t + \beta_{11} \text{ROA}_t + \beta_{12} \text{Loss}_t + \beta_{13} \text{CFO}_t + \beta_{14} \text{LaggedAccruals}_t + \beta_{15} \text{LaggedNoa}_t + \beta_{16} \text{TotalAssetGrowth}_t + \beta_{17} \text{EmploymentGrowth}_t + \varepsilon$$

$$\text{(4) DiscretionaryAccruals}_{t-1} = \beta_0 + \beta_1 \text{turnover(new job)}_t + \beta_2 \text{tenure} + \beta_3 \text{turnover(new job)}_t \times \text{tenure} + \beta_4 \text{LnMVEquity}_t + \beta_5 \text{MarketBookRatio}_t + \beta_6 \text{LitigationRisk}_t + \beta_7 \text{Leverage}_t + \beta_8 \text{InstitutionalOwnership}_t + \beta_9 \text{Merger&Acquisition}_t + \beta_{10} \text{Issuer}_t + \beta_{11} \text{ROA}_t + \beta_{12} \text{Loss}_t + \beta_{13} \text{CFO}_t + \beta_{14} \text{LaggedAccruals}_t + \beta_{15} \text{LaggedNoa}_t + \beta_{16} \text{TotalAssetGrowth}_t + \beta_{17} \text{EmploymentGrowth}_t + \varepsilon$$
\[ \beta_{13}CFO_t + \beta_{14}LaggedAccruals_t + \beta_{15}LaggedNoa_t + \beta_{16}TotalAssetGrowth_t + \beta_{17}EmploymentGrowth_t + \epsilon \]

In my third hypothesis, which shows if auditors recognize the risk associated with a CEO retiring I will use audit fees to measure the risk and effort reflected by auditors (Dechow et al. 2010). However, audit fees reflect the audit and business risk, but when irregularities are present a premium should be charged. By looking at 20 years of data, it may be able to show if there are irregularities present in the year the CEO leaves the company and therefore the audit firm may need to charge a premium. This will be able to show whether auditors are recognizing the risk of earnings management when a CEO is nearing retirement or transitioning to a new job.

(5) \( \ln(\text{audit fees})_{t-1} = \beta_0 + \beta_1\text{retire}_t + \beta_2\text{Size}_t + \beta_3\text{YE}_t + \beta_4\text{DE}_t + \beta_5\text{ROA}_t + \beta_6\text{Audit}_t + \beta_7\text{CR}_t + \beta_8\text{AR}_t + \beta_9\text{Inv}_t + \beta_{10}\text{Loss}_t + \beta_{11}\text{GoingConcern}_t + \epsilon \)

My control variables include:

- Size = the natural logarithm of the client’s total assets
- YE = binary variable, 1 if the fiscal year-end is December 31, and 0 otherwise
- DE = the book value of long-term debt divided by total assets
- ROA = income before extraordinary items divided by the previous year’s total assets
- Audit = binary variable, 1 if the firm is a Big 4 audit firm, and 0 otherwise
- CR = the ratio of current assets to current liabilities
- AR = the ratio of accounts receivable to total assets
- Inv = the ratio of inventory to total assets
- Loss = binary variable, 1 if a net loss occurred at least once in past three years, and 0 otherwise
- GoingConcern = binary variable, 1 if the opinion is a going concern, and 0 otherwise

To test H3, I will also look at the audit fees a year prior to the CEO’s departure due to retirement, because that is the period of time that auditors would have to scrutinize the financial
statements in order to ensure they are correct and accurate of the firm’s current condition. I am using the natural log of audit fees as the dependent variable, because the fees reflect both effort and risk that audit firms have internalize from a client. In this model, I will limit the sample to only firms where the CEO retired to see if auditors recognize the risk present when a CEO retires from a firm:

\[
(6) \ln(\text{audit fees})_{t-1} = \beta_0 + \beta_1\text{retire}_t + \beta_2\text{DiscretionaryAccruals}_{t-1} + \beta_3\text{Size}_t + \beta_4\text{YE}_t + \beta_5\text{FOR}_t + \beta_6\text{DE}_t + \beta_7\text{SUB}_t + \beta_8\text{ROA}_t + \beta_9\text{Audit}_t + \beta_{10}\text{CR}_t + \beta_{11}\text{AR}_t + \beta_{12}\text{Inv}_t + \beta_{13}\text{Loss}_t + \beta_{14}\text{Opinion}_t + \epsilon
\]

IV. ANALYSES

In table I located in the appendix, H1a and H1b were tested. It is shown that discretionary accruals are only significant when a CEO leaves a firm for retirement versus a new job. There is no significant change in discretionary accruals for a CEO that departs a firm for a new job. These results are consistent with my hypotheses. A CEO that is retiring may know they are retiring far in advance, giving them the opportunity to manage earnings in order to make targets and look good on the way out. A CEO that is leaving a firm for a new job may not know that is the case prior to their departure. This does not allow them a timeline in which they can manage earnings in their favor before their departure.

Table II displays the results from H2a and H2b and shows whether or not tenure affects discretionary accruals. In H2a I found that tenure does not have a significant impact on discretionary accruals. This result was inconsistent with my hypothesis and could possibly be because as a CEO’s tenure increases and they retire their tenure does not affect how much they manage earnings. In H2b I also found a result that was inconsistent with my hypothesis. I found that tenure also does not affect discretionary accruals when a CEO leaves for a new job. Tenure
does not affect discretionary accruals the year prior to the CEO’s departure, either for retirement or a new job. However, in the test for H2b I found that the turnover variable for a new job became significant at a level of 0.1.

The last test examines auditor’s recognition of the risk associated with a CEO’s departure. It is found that when a CEO retires auditors do increase their fees associated with the audit. There is a significant result that shows auditors recognize the risk of a retiring CEO and increase their effort on the audit. This result is inconsistent with my hypothesis and shows that auditors are aware of the potential risks of a retiring CEO and the opportunity to manage earnings in their final year. The second test performed for H3 found that retirement increases audit fees, not discretionary accruals. There are other risks associated with a retiring CEO in addition to managing earnings and auditors are increasing their efforts to perform an audit that thoroughly examines a firm’s financials.

V. CONCLUSION

CEO departure provides an opportunity for a CEO to manage earnings to make themselves appear better and help benefit their compensation upon departure. My study looked at firms to see if depending on the reason for the CEOs departure had an effect on their management of earnings. It was found that CEOs leaving for retirement managed earnings while those leaving for a new job did not. A CEO leaving for retirement may have few repercussions and are affected by the horizon problem. Retiring CEOs have little incentive to improve the firm and would like to increase their compensation as much as possible. Also a retiring CEO may have a definite timeline making managing earnings even easier. A CEO that is leaving a firm for a new job may not know exactly when they will depart, making it difficult to manage earnings prior to their departure.
In the second hypothesis I examine to see if tenure had an effect on the discretionary accruals of CEO departing for either retirement or a new job. My results show that the level of tenure doesn’t impact discretionary accruals with retirement. This shows that retiring CEOs may not care how much time they invested in a firm and may try to make themselves look better at the end. Also I found that CEOs departing a firm for a new job also were not influenced by tenure. This result was inconsistent with my hypothesis, I expected tenure to decrease the discretionary accruals, showing that as tenure with a firm lengthens a CEO is less likely to manage earnings. This was false and tenure does not have any impact on the discretionary accruals of a firm with a CEO departing for either retirement or a new job.

My last hypothesis was examining whether or not auditors recognize the risks associated with a CEO departing from the firm. I found that auditors increase their fees when a CEO is retiring. This shows that auditors are recognizing the risk of a retiring a CEO, but there could be other reasons besides earnings management that the audit fees are increased. In the last test it is shown that audit fees are increased in response to a CEO retirement versus high discretionary accruals. There may be other issues associated with a CEO leaving for retirement and auditors have recognized those risks and have increased their fees to compensate the extra work performed.

A limitation of my research is the results with tenure as a variable. In the test with tenure and turnover for a new job, the turnover variable became significant. It was not significant in the test of discretionary accruals without turnover. This may be an error in the data, or maybe when tenure is considered the discretionary accruals may be of significance.

My research contributes to the literature about CEO departure and the horizon problem. It shows that the horizon problem is present in retiring CEOs, but not in those that are leaving for a
new job. Also it contributes to the literature on auditors recognizing the risk of a retiring CEO. Auditors are recognizing the risk of a retiring CEO and are basing higher fees on a retiring CEO versus high discretionary accruals. Investors and boards of directors should be interested in this research, because they need to be conscious of the effects of a retiring CEO on the long term health of a firm’s financial statements. Retiring CEOs have the opportunity and timeline to manage earnings for their benefit while hurting the future of the firm. Board of Directors can carefully examine the financial statements and determine which discretionary accruals are appropriate and align with the firm’s long term success.
REFERENCES


### Table I - Testing Hypothesis 1 A & B

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### Table II - Testing Hypothesis 2 A & B

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