The State of the Literature on Audit Committee Compensation and Its Implications for Practice and Research

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SUMMARY: The compensation structure of audit committee members has shifted over time to comprise greater proportions of equity and less cash. Practitioners and researchers debate what mixture of cash and equity compensation promotes audit committee objectivity and financial reporting quality. This article summarizes the current state of the audit committee compensation literature and discusses the implications of these findings for future researchers, practitioners, and regulators.

Keywords: audit committee; audit committee compensation; cash compensation; equity compensation; financial reporting quality; stock options.

INTRODUCTION

Over the past 15 years governance practices and legislative requirements (i.e., Sarbanes-Oxley Act of 2002 [U.S. House of Representatives 2002], listing standards of the NYSE and NASDAQ, Dodd-Frank Act of 2010) have heightened audit committee accountability and shifted audit committee compensation strategies. In an effort to attract talented directors, reward them for their increased responsibilities, and align their interests with those of shareholders, organizations have moved away from primarily paying cash retainers or meeting fees (National Association of Corporate Directors [NACD] 2003) toward a cash/equity compensation structure; with equity comprising a greater proportion of director compensation (Yermack 2004). Currently, compensation packages typically include a combination of 50 to 60 percent equity and the balance in cash (Pakela and Sinkular 2017). Within the equity component, stock option grants and restricted stock are the primary methods of compensation.

The practice of compensating audit committees with greater proportions of equity has spurred a debate between researchers, policy makers, and boards of directors as to whether equity compensation encourages or undermines the effectiveness of the audit committee. The NACD recommends compensating directors with at least 50 percent in the form of equity as it argues

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greater proportions of equity align the interests of directors with the long-term interests of shareholders (NACD 2001). Since regulators have not provided any authoritative guidance on the preferable compensation method for directors, CEOs and boards of directors have adopted the NACD perspective and offered audit committees compensation packages that include greater proportions of equity and less cash.

Researchers, however, have expressed concerns that offering compensation packages with greater proportions of equity may jeopardize independence and promote a short-term orientation that impairs the audit committee’s monitoring performance and decreases financial reporting quality (Archambeault, DeZoort, and Hermanson 2008; Magilke, Mayhew, and Pike 2009). Whether equity compensation improves audit committee oversight effectiveness is an on-going debate that warrants further examination. This paper summarizes the empirical research on audit committee compensation and discusses the implications for practitioners, researchers, and regulators.

BACKGROUND

Practitioner recommendations and governance practices have shaped the manner in which the audit committee has been compensated over time. The NACD (1996) Blue Ribbon Commission Report on Director Professionalism was an initial and very influential report that provided recommendations to pay directors with cash and equity and eliminate director pensions and benefit programs that aligned too closely with management. Subsequently, in 2001 the NACD recommended that at least half of director compensation be in the form of equity, including stock options and restricted stock. This recommendation by the NACD was motivated by two factors: (1) the lack of formal guidance from regulatory entities concerning the design of director compensation packages, and (2) a desire to align the directors’ interests with the shareholders’ long-term perspective and motivate directors to perform their governance responsibilities more effectively (Dalton and Daily 2001), especially in monitoring management’s opportunistic behavior and safeguarding the interests of the shareholder (Fama and Jensen 1983). Recently, an association of chief executive officers of leading U.S. companies (the Business Roundtable [BRT]) reaffirmed the NACD’s viewpoint and endorsed a mix of cash and equity compensation (preferably long-term equity) to align the interests of directors with those of shareholders and promote a long-term focus on performance (BRT 2010).

Both the NACD and BRT recommendations, as well as the trend of organizations compensating audit committee members with increased proportions of equity, have driven academic researchers to investigate whether equity-based compensation aligns the interests of directors with shareholders or whether it compromises the audit committee directors’ monitoring ability. Overall, the results of the empirical studies suggest that audit committee equity compensation, specifically stock options, is associated with a greater likelihood of financial restatements (Archambeault et al. 2008), internal control weaknesses (Cullinan, Du, and Jiang 2010), and managed earnings (Campbell, Hansen, Simon, and Smith 2015; Rickling and Sharma 2017). Taken together, these findings provide evidence that audit committee equity compensation is associated with poor financial reporting quality and a lack of oversight by the audit committee. Cash compensation, in contrast, appears to enhance audit committee objectivity and financial reporting quality (Engel, Hayes, and Wang 2010; Rickling and Sharma 2017). These studies are discussed below.

EMPIRICAL STUDIES ON AUDIT COMMITTEE COMPENSATION

This study examines how the form of compensation affects the audit committee’s oversight effectiveness, using peer-reviewed articles published in academic journals within the Australian...
Business Dean’s Council Journal Quality list, during the period 2000–2018. Nine studies were identified by using the keyword search terms of audit committee, audit committee compensation, cash compensation, equity compensation, stock option compensation, and director compensation. Of these nine studies, two examine the role of cash compensation, five examine various forms of equity compensation, and two additional studies examine a mix of cash and equity compensation. The small number of studies available on audit committee compensation is most likely due to scholars having limited access to director compensation data until the SEC required public companies in 2006 to disclose executive and director compensation information (SEC 2006).

**Studies Examining Audit Committee Cash Compensation**

Two studies examine how cash compensation influences the audit committee’s oversight of the financial reporting process (see Table 1). Engel et al. (2010) examine how cash retainers affect the audit committee’s monitoring ability both pre-SOX (2000–2001) and post-SOX (2002–2004), using audit fees paid to the auditors as a proxy for the demand for monitoring. The authors find a positive and significant relation between cash retainers and audit fees, and that cash retainers increased on average 34 percent from the pre-SOX period to the post-SOX period. They propose that the greater the demand for monitoring of the financial reporting process, the greater the increase in cash retainers paid to the audit committee.

A second study, by Rickling and Sharma (2017), studies the effect that cash-based audit committee compensation has on the propensity of firms to beat earnings forecasts by a large margin (manage earnings). Using 2007 earnings and forecast data, they find the greater the proportion of cash paid to the audit committee; the less likely firms exceed earnings forecasts by a large margin. The authors further explore whether the power of the CEO attenuates the negative association between compensating the audit committee with cash and the likelihood of firms exceeding earnings by a large margin. They find that high CEO power weakens the negative association while low CEO power strengthens this negative relationship.

**Studies Examining Audit Committee Equity Compensation**

Five studies have examined the impact of equity compensation on financial reporting quality. Three of them focus specifically on the effect of stock options and two others on a variety of equity holdings (see Table 2). The primary reason that the majority of audit committee compensation studies examine equity compensation is the NACD’s recommendation to remunerate audit committee directors with greater equity. The findings reveal that certain forms of equity compensation may negatively affect the audit committee’s monitoring of the financial reporting process.

One of the first studies to investigate the relation between audit committee equity compensation and the quality of financial reporting is Archambeault et al. (2008). Their findings suggest that both short-term and long-term stock options are associated with a greater likelihood of an accounting restatement. From these results we can infer that stock options, whether short-term or long-term, may not encourage audit committee members to focus on high-quality financial reporting.

Cullinan et al. (2010) examine the effect of stock option compensation on financial reporting quality using internal control weaknesses as a proxy for financial reporting failure. The authors selected a sample of companies from 2004 to 2005 that reported a material internal control weakness and a matched sample of companies that did not report a material weakness. They then
| Article                        | Type of Study | Sample and Sample Period                      | Type of Compensation | Financial Reporting Quality Variable | Results                                                                 |
|-------------------------------|---------------|-----------------------------------------------|----------------------|--------------------------------------|------------------------------------------------------------------------|
| Engel et al. (2010)           | Archival      | 3, 295 firm year observations (2000–2004)    | Cash retainer and total compensation | Audit fees                          | • Greater total compensation is associated with higher demands for monitoring  |
|                               |               |                                               |                      |                                      | • Cash retainers are associated with higher demands for monitoring     |
| Rickling and Sharma (2017)    | Archival      | 1,008 firms (2007)                           | Proportion of cash compensation to total compensation | Propensity of firms to beat forecasted earnings by a large margin | • The greater the proportion of cash paid to the audit committee the less likely firms exceed forecasted earnings by a large margin |
| Article                        | Type of Study | Sample and Sample Period                                                                 | Type of Compensation                                                                 | Financial Reporting Quality Variable          | Results                                                                                      |
|-------------------------------|---------------|------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------------------------------------------------------|
| Archambeault et al. (2008)    | Archival      | 153 firms with restatements, 153 with non-restatements (1999–2002)                       | Short-term (vesting in less than one year) and long-term stock option grants (vesting in greater than one year) | Accounting restatements                       | • Short-term stock option grants are associated with a greater likelihood of a restatement    |
|                              |               |                                                                                         |                                                                                        |                                               | • Long-term stock option grants are associated with a greater likelihood of a restatement       |
| Cullinan et al. (2010)        | Archival      | 162 pairs of companies with ICW and non-ICW (2004–2005)                                   | Existence of a stock option plan for the audit committee                                 | Internal control weakness (ICW)               | • Firms that have a stock option plan for their audit committee members are more likely to report internal control weaknesses |
| MacGregor (2012)              | Archival      | 1,370 observations with earnings near prior year levels and 2,389 observations near analysts’ forecasts (1999–2003) | Equity holdings (average holdings/diluted shares outstanding at fiscal year-end)        | Likelihood of a firm meeting prior year earnings and analysts’ forecasts | • When the audit committee is compensated with equity holdings, the firm is likely to meet the earnings threshold and analysts’ forecasts |
| Keune and Johnstone (2015)    | Archival      | 493 firms with individual misstatements, 225 firms with aggregated misstatements (2003–2006) | Short-term stock options (vesting within one year) and long-term stock options (vesting greater than one year) | Income-decreasing and income-increasing misstatements | • Influence of equity holdings varies with the risk of reporting problems                      |
|                              |               |                                                                                         |                                                                                        |                                               | • Short-term stock option compensation increases the likelihood of managers waiving material misstatements in order to meet or beat short-term earnings forecasts |
|                              |               |                                                                                         |                                                                                        |                                               | • Long-term stock option compensation motivates managers to waive misstatements in order to accumulate reserves when the company reports missing, meeting, or beating analysts’ forecasts |

(continued on next page)
| Article          | Type of Study | Sample and Sample Period | Type of Compensation | Financial Reporting Quality Variable | Results                                                                                                                                 |
|-----------------|---------------|--------------------------|----------------------|--------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------|
| Campbell et al.  | Archival      | 2,172 firm year          | Exercisable stock options, annual stock option awards, stock holdings | Likelihood of the firm meeting or beating analysts' earnings forecasts | Exercisable stock options and annual stock option awards are associated with a higher likelihood of meeting or beating analysts' forecasts. Stock holdings have no effect on financial reporting quality. |
| (2015)           | Archival      | observations (2006–2008)  |                      |                                      |                                                                                                                                          |
examined whether the firms offered their audit committee a stock option plan as part of their compensation package. The authors identified that firms that reported a material internal control weakness were more likely to compensate their audit committee members with stock options than those firms that did not have an internal control weakness.

In contrast to the previous two studies that examine stock options, MacGregor (2012) examines the relation between audit committee equity holdings and the likelihood of a firm meeting prior year earnings and analysts’ forecasts using a sample of firms between 1999 and 2003. He finds that the level of influence of equity holdings on managing earnings varies with the risk of reporting problems. When the risk is high (firms offer higher CEO equity compensation and have high-risk assets), equity holdings enhance audit committee effectiveness by motivating audit committee members to restrict managerial discretion over financial reporting. When the risk is low, equity holdings motivate audit committee members to allow greater management discretion over financial reporting policies, increasing the likelihood of managing earnings. MacGregor (2012) proposes that we must consider the risk environment when evaluating the effect of equity compensation.

Keune and Johnstone (2015) also examine audit committee stock option compensation and its effect on financial reporting quality. Using short-term options (vesting in one year or less) and long-term options (vesting in more than one year), they study whether these types of stock options affect the likelihood that audit committees will allow managers to waive detected misstatements in order to meet or beat earnings forecasts. The authors find that compensating audit committee members with short-term stock options is associated with a greater likelihood of managers waiving income-decreasing material misstatements in order to meet or beat short-term earnings forecasts. In contrast, when the audit committee is compensated with long-term stock options, managers tend to waive income-increasing misstatements when the firm reports missing or barely meeting analyst forecasts in order to accumulate reserves for future periods.

Campbell et al. (2015) provide further empirical evidence on the mix of equity compensation (stock options, stock awards, and restricted stock) and financial reporting quality in the post-SOX environment. They examine how various types of compensation affect financial reporting quality using (1) the likelihood of the firm meeting or beating the analysts’ earnings forecast, and (2) the level of discretionary accruals. Both of these measures provide evidence of the likelihood of a company managing earnings in order to achieve expected financial results; thereby potentially lowering financial reporting quality. Using data from 2006 to 2008 they find that both exercisable options and total stock option compensation are associated with a higher likelihood of firms meeting or beating analysts’ forecasts and the level of discretionary accruals. In contrast, they find that stock awards and restricted stock holdings have no effect on financial reporting quality.

**Studies Examining a Mix of Audit Committee Cash and Equity Compensation**

Only two studies have used a mix of cash and equity compensation to examine the effect of incentives on audit committee members’ objectivity and financial reporting quality (Bierstaker, Cohen, DeZoort, and Hermanson 2012; Magilke et al. 2009). Both of these studies use experimental settings as this type of environment enables researchers to directly observe audit committee objectivity and explore the impact of various types of incentives on the audit committee’s decision-making process (see Table 3).

Magilke et al. (2009) investigate whether cash and stock-based compensation affects the objectivity of audit committee members. Using a between-subjects design, the authors conduct six independent sessions in each of the audit committee compensation plan treatments: (1) only cash,
### TABLE 3

**Summary of Studies Examining a Mix of Audit Committee Cash and Equity Compensation**

| Article                  | Type of Study | Participants                           | Type of Compensation                                                                 | Variable Examined                                      | Results                                                                 |
|--------------------------|---------------|----------------------------------------|---------------------------------------------------------------------------------------|-------------------------------------------------------|------------------------------------------------------------------------|
| Magilke et al. (2009)    | Experimental  | 3 participants × 6 independent sessions | (1) Cash only, (2) cash plus a bonus based on current investment gains, and (3) cash plus a bonus based on future investor gains | Objectivity of the audit committee members (ACMs)      | • Cash compensation motivates objective reporting                     |
|                          |               |                                        |                                                                                       |                                                        | • Stock-based compensation (current and future-based) promotes more biased decisions |
|                          |               |                                        |                                                                                       |                                                        | • ACMs compensated with stock-based compensation tied to future profits are more conservative than those compensated with stock tied to current profits |
|                          |               |                                        |                                                                                       |                                                        | • Audit committee members compensated with cash and long-term stock options were more likely to favor the auditor in a dispute |
|                          |               |                                        |                                                                                       |                                                        | • Audit committee members compensated with cash or a mix of cash and short-term stock options were neither more nor less likely to favor the auditor in a dispute |
| Bierstaker et al. (2012) | Experimental  | 56 audit committee members             | (1) Cash, (2) Cash plus short-term stock options, (3) Cash plus long-term stock options | Accounting disagreement between the manager and external auditor |                                                        |
(2) cash plus a bonus tied to current year-end profits, and (3) cash plus a bonus tied to future investor profits, similar to unvested options or restricted stock. Participants acting as audit committee members are asked to respond to several scenarios under the three different incentive conditions. The authors find that participants compensated with only cash made more objective decisions than those compensated with a combination of cash and stock-based compensation. They also find that those compensated with a combination of cash and stock-based compensation tied to future profits made more conservative decisions than those remunerated with cash and stock-based compensation tied to current earnings.

Similarly, Bierstaker et al. (2012) study the effect of three types of compensation packages (cash only, cash plus short-term stock options, and cash plus long-term stock options) on audit committee members’ judgments using an accounting disagreement between the manager and external auditor. The authors use 56 public company highly experienced audit committee members as participants and find that the audit committee members are more likely to support the auditor in an accounting dispute when their compensation includes long-term stock options. In contrast, audit committee members compensated with short-term stock options or cash compensation were neither more nor less likely to favor the auditor in the dispute.

**IMPLICATIONS FOR PRACTICE, POLICY, AND RESEARCHERS**

*Implications for Practice and Policy*

The empirical results of the studies on audit committee compensation provide evidence that certain forms of equity compensation appear to impair the audit committee’s monitoring effectiveness and the quality of financial reporting. Specifically, stock options are associated with a greater likelihood of firm restatements (Archambeault et al. 2008), internal control weaknesses (Cullinan et al. 2010), or managed earnings (Campbell et al. 2015; Keune and Johnstone 2015). Cash compensation, in contrast, seems to promote greater oversight of the financial reporting process, as greater cash compensation is related to a lower likelihood of firms exceeding analysts’ earnings forecasts (Rickling and Sharma 2017).

These results have implications for organizations today as they imply that compensating audit committee directors with equity (specifically stock options) may not align the interests of directors with those of shareholders; rather it may encourage audit committee members to focus on short-term performance to the detriment of providing effective oversight. Organizations may therefore wish to offer compensation packages that include greater amounts of cash as well as consider the risk environment of the firm when determining the compensation mix (MacGregor 2012). Additionally, given that the empirical results seem to contradict the NACD and BRT recommendations on director compensation, these associations may want to contemplate revising their recommendations and encouraging organizations to carefully consider the motivational effects of director compensation packages so that they are better aligned with the goals of the organization.

Finally, Rickling and Sharma (2017) provide some evidence that the power of the CEO may play a role in how audit committee members are compensated. They find that a powerful CEO may undermine the audit committee’s oversight tasks by providing the audit committee with greater amounts of equity compensation and less cash. In an effort to promote audit committee objectivity, organizations should consider reducing CEO involvement in the design of director compensation packages.
Implications for Researchers

From the studies on audit committee compensation we can infer that equity incentives may lead to poor governance while cash compensation may promote audit committee objectivity, despite recommendations from the NACD and BRT that suggest otherwise. These findings have implications for researchers and graduate students as they suggest further research is needed to evaluate the effects of the various forms of compensation on audit committee behavior.

To date, only two studies have explored the mix of cash and stock options (Magilke et al. 2009; Bierstaker et al. 2012) and very little is known regarding the appropriate combinations of cash and equity or the threshold at which equity compensation may promote governance versus undermining it. The NACD has recommended compensating directors with at least 50 percent in the form of equity; however, the literature has not explored the effect of different percentages of cash or equity on the audit committee’s monitoring ability. Future researchers should consider examining a combination of cash and other forms of equity (stock awards and restricted stock) as well as what happens when compensation moves from a low proportion to a high proportion of cash and equity.

Researchers and graduate students should use both archival and experimental methods to examine the effects of short-term and long-term stock options, as the current literature has not identified whether short-term or long-term stock options can be more harmful. Researchers should also examine the effects of other types of options that have not been explored, such as exercisable and unexercisable options.

CONCLUSION

The debate on whether equity compensation is advantageous or detrimental for effective oversight by the audit committee is still ongoing. A review of the current literature on audit committee compensation provides evidence that economic incentives affect the audit committee’s monitoring ability. Equity compensation seems to be associated with less effective oversight while cash compensation motivates audit committee members to be more objective. Further research is needed to determine the appropriate pay structure for audit committees.

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