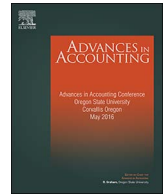




Contents lists available at ScienceDirect

Advances in Accounting

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

Managerial ability and real earnings management

Xuerong (Sharon) Huang^{a,*}, Li Sun^b^a Miller College of Business, Ball State University, Muncie, IN 47306, United States^b Collins College of Business, University of Tulsa, Tulsa, OK 74104, United States

ARTICLE INFO

Keywords:

Managerial ability
 Real earnings management
 Abnormal production costs
 Abnormal discretionary expenses
 Future firm performance

ABSTRACT

Prior studies investigate the determinants and consequences of real earnings management (REM) as a function of firm-specific characteristics. In this study, we examine how managerial ability relates to the use of REM and future firm performance. We find that higher-ability managers engage in less REM. Furthermore, we find that managers with superior ability reduce the negative impact of REM on future firm performance. This is consistent with prior studies, which link higher-ability managers to better management of firm resources and more positive outcomes.

1. Introduction

This study examines the role of managerial ability in real earnings management (REM). REM is manager's purposeful action that deviates from the optimal business practice to alter reported earnings in a particular direction (Roychowdhury, 2006). Prior studies (e.g., Cohen & Zarowin, 2010; Zang, 2012) focus on firm-level characteristics (e.g., the relative costs and constraints of REM and accrual-based earnings management) that lead to manager's choice of REM. However, in addition to firm-level characteristics, executive characteristics may affect the use of REM. Our study investigates the relation between managerial ability and the use of REM. Furthermore, prior studies (e.g. Bhojraj, Hribar, Picconi, & McInnis, 2009; Cohen & Zarowin, 2010) suggest that REM is a value-destroying activity and has a negative impact on future firm performance. Our study sheds new light on the role of managerial ability in the relation between REM and future firm performance.

We predict that managers' ability to efficiently convert firm resources into sales is negatively related to REM for the following reasons. First, for a given set of resources the company owns, higher-ability managers are capable of generating higher sales revenue and thus are less likely to be under the pressure of earnings management. Next, high-ability managers understand the negative impact of REM on future firm performance (Cohen & Zarowin, 2010; Roychowdhury, 2006), and therefore they are more reluctant to engage in REM. Finally, the opportunity cost is a significant factor in managers' decision-making model. Because managers have limited time and effort, more-talented managers would rather devote greater effort to the normal operations than to REM.

However, a negative relation between managerial ability and the use of REM may not exist. First, all else equal, all managers face the pressure of meeting or beating the earnings benchmarks. Given the high reputation cost of the high-ability managers,¹ they might face even more pressure if they miss the earnings benchmarks. Therefore, when facing the earnings benchmarks, more-talented managers might engage in REM. Second, higher-ability managers have a superior knowledge of their firms' operating environment (Demerjian, Lewis, Lev, & McVay, 2013), which enables them to align REM with their reporting strategies. Third, if the majority of variation of REM is driven by these firm characteristics identified in the prior literature, we might fail to find a meaningful effect of managerial ability on REM. Collectively, the relation between managerial ability and REM is still an empirical question.

Some studies (e.g., Roychowdhury, 2006) document a negative relation between REM and future firm performance. We expect high-ability managers to reduce the negative effect of REM on future firm performance for the following two reasons. First, given the superior understanding of their firms and their firms' operating environment, higher-ability managers can better align the firms' operating decisions with financial reporting strategies and therefore choose less value-destroying REM. Second, as noted in the prior literature, REM is a complex task that requires managers to forecast the firm's future earnings and identify the shortfalls between the unmanaged future earnings and the ideal thresholds (Roychowdhury, 2006). Given the superior knowledge of more-able managers, it is expected that they are able to estimate the future earnings and identify shortfalls earlier than are less-able managers, therefore more-able managers have more choices and thus are less likely to choose the costly REM.

We follow Roychowdhury (2006) and Kothari, Mizik, and Roychowdhury

* Corresponding author at: Miller College of Business, Ball State University, Muncie, IN 47306, United States.

E-mail addresses: xhuang2@bsu.edu (X.S. Huang), li-sun@utulsa.edu (L. Sun).

¹ Demerjian et al. (2013) suggest that managerial ability is positively associated with CEO reputation.

<http://dx.doi.org/10.1016/j.adiac.2017.08.003>

Received 5 November 2015; Received in revised form 3 August 2017; Accepted 8 August 2017

0882-6110/ © 2017 Published by Elsevier Ltd.

(2016) to calculate abnormal production costs and abnormal discretionary expenses, which are proxies of our REM measures. Consistent with Zang (2012), we also use an aggregate REM measure, which combines the abnormal production costs and abnormal discretionary expenses. We operationalize managerial ability by using a measure developed by Demerjian, Lev, and McVay (2012). This measure captures managers' ability to efficiently convert firm resources into sales revenue relative to their industry peers. In other words, higher-ability managers are more likely to generate more sales revenue for a given set of resources compared to lower-ability managers. Using a panel sample of 69,429 firm-year observations from 1987 to 2012, we find that (1) managerial ability is negatively related to the use of REM, and (2) higher-ability managers better reduce the negative impact of REM on future firm performance. In addition, we also test our two hypotheses using three alternative managerial ability measures: CEO tenure, lagged managerial ability rank, and the rolling average of managerial ability rank of the most recent two years. We still find similar results. Furthermore, we find that higher-ability managers prefer to use accrual-based earnings management or classification shifting earnings management than REM. These results suggest that higher-ability managers better understand the negative impact of REM on future firm performance and tend to use other methods of earnings management instead of REM. We further find that when these higher-ability managers use accrual-based earnings management and classification shifting earnings management, their earnings management is associated with better future firm performance, relative to low-ability managers.

Our study makes several contributions. First, most prior studies on REM focus on firm-level characteristics as determinants and fail to examine the influence of individual managers. Our study extends managerial ability framework to the REM setting. To the best of our knowledge, this study is the first study that examines the relation between managerial ability and the use of REM. Second, prior research documents a negative impact of REM on future firm performance. This study sheds new light on the role of managerial ability in the relation between REM and future firm performance. Third, this study contributes to the literature linking managerial ability to financial reporting quality (Demerjian et al., 2013; Demerjian, Lewis-Western, & McVay, 2017) and other managerial decision-making outcomes (Koester, Shevlin, & Wangerin, 2016).

The remainder of this paper is organized as follows. Section 2 reviews related studies and presents the hypotheses development. Section 3 presents the research design, including the measurement of primary variables and the empirical specification. Section 4 discusses the sample selection and descriptive statistics. Section 5 discusses the results of our main analysis, and Section 6 presents the results of additional tests. Section 7 concludes the paper.

2. Literature review and hypothesis development

2.1. Real earnings management and firm performance

Real earnings management (REM) is defined as management operational activities to alter reported earnings in a particular direction, which is achieved by overproducing inventory to lower the cost of goods sold (COGS) or cutting discretionary expenses (i.e., advertising expenditures, research and development expenditures, selling, general and administrative expenditures) to improve reported margins. In other words, REM is the management action that deviates from normal business practices and has suboptimal business consequences.

Using a survey of top executives, Graham, Harvey, and Rajgopal (2005) find that managers have stronger willingness to manage earnings through REM than through accruals. This is the case for at least two reasons. First, REM is less likely to be scrutinized by auditors and regulators, and therefore has a high probability of not being detected. Second, accrual-based earnings management is constrained by the accounting flexibility within the firm. For example, due to the reversing nature of accruals, firms' aggressive estimates and judgments used in the previous periods prevent them from making similar estimates and

judgments in the subsequent periods. Consistent with the suggestions in Graham et al. (2005), Cohen, Dey, and Lys (2008) find that firms switch from accrual-based earnings management to REM following the passage of Sarbanes-Oxley Act (SOX) in 2002. This result implies that the need to avoid the detection of accrual-based earnings management is greater in the post-SOX period than in the pre-SOX period, which induces managers to switch from accrual-based earnings management to REM.

Early REM research focuses on the manipulation of R&D expenditures (e.g., Baber, Fairfield, & Haggard, 1991; Bushee, 1998; Dechow & Sloan, 1991). Roychowdhury (2006) finds that managers engage in other types of operational activities in addition to cutting R&D expenditures (i.e., overproduce to lower COGS and cut discretionary expenditures) to avoid reporting losses or missing analyst forecasts. In addition, alternative REM activities documented in the prior literature include cutting advertising expenditures (Cohen, Dey, Mashruwala, & Zach, 2010), sale of profitable assets (Bartov, 1993), sales price reductions (Jackson & Wilcox, 2000), derivative hedging (Barton, 2001), and stock repurchase (Hribar, Jenkins, & Johnson, 2006).

Given the increased use of REM since the passage of SOX in 2002, numerous studies have examined the relation between REM and future firm performance. Roychowdhury (2006) suggests that REM has a negative effect on a firm's performance by stating that "real activities manipulation can reduce firm value because actions taken in the current period to increase earnings can have a negative effect on cash flows in future periods" (p. 338). Cohen and Zarowin (2010) examine the relation between real earnings management activities of Seasoned Equity Offerings (SEO) firms and post-SEO firm performance, and they find that the decline in post-SEO operating performance is largely due to REM activities. Eldenburg, Gunny, Hee, and Soderstrom (2011) investigate the REM in a nonprofit setting and find weak evidence suggesting the use of REM in hospitals and a possible negative impact of REM on future performance. Abernathy, Beyer, and Rapley (2014) argue that the use of REM may hurt a firm's future performance. For example, if managers cut R&D expenditures to increase current year earnings, the future performance may be hurt due to the lost opportunities from reduced R&D activities. Taken together, the above-mentioned studies suggest a negative relation² between REM and future firm performance. However, most prior studies examine the effect of REM on future firm performance as a function of firm-level characteristics and fail to examine the influence of individual managers.

2.2. Management style and managerial ability

Most corporate decisions research focuses on firm-level characteristics as determinants. A separate stream of research investigates the influence of individual managers on corporate decisions. Upper echelons theory (i.e., Hambrick, 2007; Hambrick & Mason, 1984) states that managerial characteristics (at least) partially influence organizational outcomes. Following this theory, Bertrand and Schoar (2003) find that CEOs have different styles of management, which affect a wide range of corporate decisions. Bertrand and Schoar (2003) set up the foundation for the 'management style' literature. The management style research continues to examine the relation between CFO expertise and restatements (Aier, Comprix, Gunlock, & Lee, 2005), CEO reputation and earnings quality (Francis, Huang, Rajgopal, & Zang, 2008), managerial style and firm voluntary disclosure (Bamber, Jiang, & Wang, 2010), managerial style and corporate tax avoidance (Dyreng, Hanlon, & Maydew, 2010), and CFO style and accounting policies (Ge, Matsumoto, & Zhang, 2011). Collectively, these studies provide evidence supporting the importance of managerial characteristics in corporate decisions and performance.

² Gunny (2010) suggests that managers who engage in REM to just meet earnings benchmarks have better subsequent performance than firms that do not engage in REM and miss earnings benchmarks.

متن کامل مقاله

دریافت فوری ←

ISIArticles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات