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Financial Expert CEOs and Earnings Management Around Initial Public Offerings[☆]

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ABSTRACT

This study examines the association between financial expert CEOs and earnings management (EM) around initial public offerings. We identify financial expert CEOs as those having past experience in either banking or investment firms, large auditing firms, or finance-related roles. We find strong evidence that newly listed firms with financial expert CEOs are less likely to engage in either accrual-based or real EM in the offering year than those with non-financial expert CEOs. In particular, our results are robust after controlling for the potential selection issue that occurs due to non-random matching of CEOs to firms. In addition, we employ alternative measures of financial expertise, including past experience in a CFO position, financial experience variety, and professional qualifications. We document that CEOs who used to work as CFOs and those who gained varied financial experience are less likely to manage earnings through both accruals and real activities. Moreover, CEOs who have a professional qualification in finance and/or accounting are also associated with lower accrual-based EM.

1. Introduction

Earnings are widely used by investors to evaluate firms' prospective performance and managers are tempted to manipulate earnings to influence short-term stock prices. The incentives to engage in earnings management (EM) are stronger around initial public offerings (IPOs) due to the high level of information asymmetry between managers and investors. Prior research on EM around IPOs has provided evidence for positive abnormal accruals in the year of issue and a negative relation between at-issue abnormal accruals and post-issuelong-run stock performance, suggesting that managers manipulate earnings to mislead investors (Aharony, Lin, & Loeb, 1993; DuCharme, Malatesta, & Sefcik, 2004; Friedlan, 1994; Gramlich & Sorensen, 2004; Roosenbloom & van der Goot, 2003; Teoh, Welch, & Wong, 1998a; Teoh, Wong, & Rao, 1998b).

Given the prevalence of the EM issue, researchers have extensively explored the determinants of EM, such as firm-level factors (e.g.,firm size, firm performance, leverage, growth, corporate governance, financing needs, and target beating) and external factors (e.g.,capital requirements and regulations; see Dechow, Ge, & Schrand, 2010, for a review). In the IPO context, several studies suggest

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the significance of external parties such as auditors, underwriters, venture capitalists, and credit rating agencies in restraining EM by IPO firms (Gounopoulos & Pham, 2017; Hochberg, 2012; Lee & Masulis, 2011; Morsfield & Tan, 2006; Venkataraman, Weber, & Willenborg, 2008; Wongsunwai, 2013). Moreover, increasing attention has been paid to examining manager-level factors driving EM. Research on the effects of managerial characteristics on accounting choices is primarily based on the upper echelons theory (Hambrick, 2007; Hambrick & Mason, 1984), which postulates that managerial background characteristics may partially influence top managers' decision-making and organizational outcomes. Prior literature has documented the link between earnings quality and several managerial characteristics such as CEO reputation (Francis, Huang, Rajgopal, & Zang, 2008), superstar CEOs (Malmendier & Tate, 2009) and managerial ability (Demerjian, Lev, Lewis, & McVay, 2013). However, to the best of our knowledge, the impact of CEOs' financial experience on EM around IPOs remains unexplored.

The financial career background of CEOs may play an important role in determining the quality of financial reporting. The financial skills and experience that CEOs have accumulated over their career equip them with deeper understanding of financial and accounting issues, which they may draw upon to make proper accounting decisions and improve the financial reporting process. Moreover, extensive experience and interaction with the financial market make financial expert CEOs highly aware of the type of information demanded by investors and appreciative of the significance of accounting information in affecting investors' firm evaluation (Custódio & Metzger, 2014). Thus, financial expert CEOs may have more incentives to provide high-quality financial reporting to the market so that investors can appropriately gauge the firms' values. Furthermore, although CEOs are not directly involved in overseeing the accounting process, they can set the tone from the top and influence the decisions of chief financial officers (CFOs) (Feng, Ge, Luo, & Shevlin, 2011). The financial background facilitates communication between CEOs and CFOs, allowing them to effectively work together to develop sound accounting policies. Moreover, financial expert CEOs who hold a professional qualification are required to adhere to ethical codes of conduct, considerably influencing their risk attitudes towards greater conservatism in financial reporting. In addition, detection of financial reporting misrepresentations will adversely affect the reputation of financial expert CEOs. Thus, reputational concerns may restrain financial expert CEOs from managing earnings.

Therefore, we are interested in investigating whether the variation in the EM of IPO firms is partially attributable to CEOs' past financial experience. We collect detailed CEO profiles of our sample of U.S. common share IPOs over the period 2003–2011 from Boardex. Based on CEOs' employment histories, we categorize financial expert CEOs as those having past experience in either banking or investment firms, large auditing firms, or finance-related roles, such as an accountant, a treasurer, a vice president (VP) of finance, and a CFO. We find that IPO firms with a financial expert CEO are less likely to engage in both accrual-based and real EM around IPOs. In addition, we employ the propensity score matching method to address the potential endogenous selection bias issue that occurs due to the non-random matching of CEOs to firms and the correlation of unobserved firm and/or CEO characteristics with CEOs' financial experience. Our results still hold after controlling for endogenous selection.

Moreover, investigating the interaction effect between financial expert CEOs and CEO power, we document that CEO power significantly enhances the impacts of financial expert CEOs on accrual-based EM. This suggests that although CEOs are not directly responsible for overseeing the financial reporting process, financial expert CEOs' decision-making power allows them to more effectively influence CFOs' decisions. In addition, we employ several different measures of financial expertise, including past experience in a CFO position, financial experience variety, and professional qualifications. We find a negative relationship between CEOs' past experience as a CFO and both accrual-based and real EM. In regard to the variety of financial experience, we employ the principal component analysis to measure an index for financial experience variety that takes four aspects of CEOs' financial work experience into account (a)the number of firms in which the CEO acquired financial experience, (b)the number of financial roles in which the CEO worked, (c)whether the CEO had financial experience in another firm, and (d)the duration of the financial experience. We document that CEOs with varied financial experience are associated with lower accrual-based and real EM. Additionally, in examining the effects of CEOs with a professional qualification on EM, we find that accrual-basedEM is significantly lower when the CEO holds a professional qualification in accounting and/or finance.

Our study makes several contributions to the EM, IPO, and management literature. First, it adds to the growing literature on determinants of EM by highlighting CEOs' financial experience as a new dimension of influencing factors to be further explored in future research. Prior literature has documented the significance of CEOs' past managerial experience on accounting choices. For example, Demerjian etal. (2013) argue that managerial ability is positively related to earnings quality. They measure the ability of managers based on the extent of their efficiency in utilizing the firm's resources. Our research is distinguishable from their study, as we examine a different perspective of managerial skills—that is, the functional experience of CEOs and, specifically, their career background in finance. With regard to financial experience, Custódio and Metzger (2014) document the impact of financial expert CEOs on firms' financial policies, such as cash holdings, debts, and share purchases. We provide additional evidence of the relevance of CEOs' financial experience to firms' accounting decisions.

Another paper close to ours is the one by Jiang, Zhu, and Huang (2013) that documents a negative association between CEOs with financial experience and real EM among Chinese listed firms. We examine the impact of financial expert CEOs on EM in the IPO context. The IPO market is a more favorable setting to explore the incentives of managers in undertaking EM because managerial opportunism is more strongly driven by information asymmetries (Dye, 1988; Trueman & Titman, 1986), which are strongly manifested around IPOs. In particular, in order to have a comprehensive view of EM activities, we analyze both accrual-based and real EM. In addition, the prior literature on EM around IPOs has mainly explored the impact of external parties, such as auditors, reputable underwriters, venture capitalists, and credit rating agencies, on EM by IPO issuers (Gounopoulos & Pham, 2017; Hochberg, 2012; Lee & Masulis, 2011; Morsfield & Tan, 2006; Venkataraman etal., 2008; Wongsunwai, 2013). To the best of our knowledge, our study is the first to provide the empirical evidence of the influence of a manager-level factor—CEOs' financial experience—on EM around IPOs. The paper also contributes to the management literature by providing evidence consistent with the upper echelons