Research in Accounting Regulation 25 (2013) 88–100

Contents lists available at SciVerse ScienceDirect

Research in Accounting Regulation

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

Research Report

CEO/CFO characteristics and financial reporting quality: A review

Ahsan Habib [a,*], Mahmud Hossain [b,1]

[a] School of Business and Law, Auckland University of Technology, Private Bag 92006, Auckland 1142, New Zealand
[b] School of Accounting (Building 407, Room 411C), Curtin University, GPO Box U1987, Perth, WA 6845, Australia

ARTICLE INFO

Article history:
Available online 12 December 2012

Keywords:
Corporate governance
CEO overconfidence
CEO gender
Financial reporting quality

ABSTRACT

This study reviews the literature on the association between different facets of CEO/CFO characteristics and the properties of accounting information. The review is organized around three broad themes, namely, the association between financial reporting quality and CEO/CFO turnover, the effect of managerial overconfidence on financial reporting outcomes, and finally the effect of CEO/CFO gender on reporting outcomes. This review illustrates the importance of considering CEO/CFO characteristics as an important determinant of financial reporting outcomes. This study offers insights to policy makers interested in enhancing the governance function to enhance the credibility of financial reporting. The review informs regulators that designing governance structure disregarding CEO/CFO characteristics may not bring desired benefits.

Introduction

A key question in leadership research is whether chief executive officer (CEO) matters. Proponents of the 'CEOs matter' hypothesis argue that top leaders headed by the CEO formulate a collective purpose that unites participants in an organization and decide on the organization's course of action in the face of rapid technological and environmental changes (Mackey, 2008). Opponents of this view, in contrast, argue that CEOs are so constrained by their environment that they have little ability to affect company performance. For instance, a company's culture, the structure of its industry, and its fixed assets are all constraining factors that reduce the CEOs ability to take actions that will have an impact on the company (Wasserman, Nohria, & Anand, 2010, chap. 2). Early research on the CEO effect attributed firm performance to firm and industry effects rather than to the CEO effect. For example, Lieberson and O'Connor (1972) find that the CEO effect explains only about 6.5% to 14.5% of the variation in firm performance, much lower than the variation explained by the industry and firm effects. However, Wasserman et al. (2010, chap. 2) find that the CEO impact differs markedly by industry and that CEOs have the most significant impact where opportunities are scarce or where CEOs have slack resources. Mackey (2008) provides robust evidence in support of the 'CEO matters' hypothesis by documenting a much stronger CEO impact at the corporate level. Given that these studies employ an accounting performance measure to gauge the CEO effect, CEOs have strong reasons to take a keen interest in accounting information.

CEOs are appointed with the expectation that they will take sensible management decisions to maximize shareholder value (Armstrong, Guay, & Weber, 2010). The information in financial statements allows outsiders to gauge how efficient the CEO is in fulfilling such an expectation. Boards of directors consider operating performance to be one of the most critical factors in deciding whether to terminate the employment of poorly performing CEOs, thus providing incentives for CEOs to report better operating performance. CEOs also take an interest in accounting numbers—and profits in particular—because their compensation incentives are closely tied to reported earnings. Beginning with the seminal study of Healy (1985), a sizable volume of academic research has provided strong evidence

* Corresponding author. Tel.: +64 9 921 9999.
E-mail addresses: ahsan.habib@aut.ac.nz (A. Habib), Mahmud.Hossain@curtin.edu.au (M. Hossain).
[1] Tel.: +61 8 9266 7742.

1052-0457/$ - see front matter © 2012 Elsevier Ltd. All rights reserved.
http://dx.doi.org/10.1016/j.racreg.2012.11.002

of earnings manipulation by CEOs whose compensation is tied to earnings and stock options (Dechow, Ge, & Schrand, 2010). Although CEOs are not directly involved in the preparation of financial statements, research shows that CEOs put pressure on chief financial officers (CFOs) to engage in material accounting manipulation to meet or beat market expectations (Mei, Ge, Luo, & Shevlin, 2011). This review, therefore, considers both the CEO and CFO characteristics and their impact on financial reporting quality.

This focus on short-termism led to a spate of corporate collapses experienced by the corporate America in the beginning of this millennium. The passage of the Srabanes-Oxley (SOX) Act (2002) responds to such a crisis by making top management more accountable for their actions. Section 302 under the act, requires upper management not only to certify its company's financial reports, but also to take responsibility for any erroneous or misleading statements within them. Such a regulatory prescription will allow an efficient managerial labor market to punish the culpable managers. We begin by reviewing the strand of literature that examines the efficiency of managerial labor market in terms of disciplining managers who deliver low quality financial reports.

While these reforms may be desirable from a market perspective, their efficacies are unlikely to be realized unless the roles of management, particularly CEO characteristics in corporate governance are considered (Carcello, Hermanson, & Ye, 2011). Academic research (e.g., Skala, 2008) indicates that CEO behavioral characteristics such as overconfidence and gender play an important role in corporate policy decisions such as financing, dividends and corporate governance. Overconfident managers have been found to issue more optimistic management forecasts, engage in income-increasing earnings management, and become involved in fraudulent activities (Hribar & Yang, 2010; Schrand & Zechman, 2012). The accumulated findings from the overconfidence research indicate that overconfident CEOs are undesirable. However, overconfident CEOs are also found to be better innovators. CEO overconfidence is associated with riskier projects, greater investment in innovation, and greater innovation as. These contrasting effects of CEO overconfidence reiterate the importance of considering CEO characteristics in governance regulation.

A related but much more visible characteristic of CEOs hypothesized to influence managerial reporting behavior is CEO gender. Ethical differences between the genders have been widely examined in the business ethics literature. This stream of literature suggests that women and men exhibit distinctly different values and interests and vary in their inclination to engage in unethical business behavior (Betz, O'Connell, & Shepard, 1989; Gilligan, 1982). Men are interested in economic benefits and a successful career, and are more likely to break rules to achieve competitive success, whereas women lean towards harmonious relationships and helping others, and are less likely to be unethical (Betz, O'Connell, & Shepard, 1989; Butz & Lewis, 1996; Mason & Mudrack, 1996). CEO and CFO gender differences therefore provide an interesting basis for examining the effect of gender on financial reporting quality.

We extend two recent review studies published in *Journal of Accounting and Economics* on financial reporting quality. Dechow et al. (2010) reviewed a vast body of 'earnings quality' research and the role of 'firm fundamentals' in determining the cross-sectional variation in earnings quality. Our paper does not follow that path. Although we review research associated with 'financial reporting quality', we focus on the role of CEO/CFO characteristics (e.g., managerial overconfidence, managerial talent, gender). To the best of our knowledge, no review has yet been done on this association. Armstrong et al. (2010) is the other review paper that argues that the lack of information transparency (arising from information asymmetry) between managers and outside directors adversely affects the corporate board structure. We argue that information asymmetry, between managers and outside directors, could also arise from CEO characteristics, e.g., behavioral bias (derives from self disposition bias) and gender. This emerging literature was not reviewed by Armstrong et al. (2010). Therefore, our study sheds new light on the role of CEO in the information environment between insiders and outside directors. We also believe that our review will assist the future researchers to understand the role of management in accounting and governance since the extant studies do not incorporate the role of management in accounting, auditing and governance studies (Carcello, Hermanson, et al., 2011).

We proceed as follows. 'Financial reporting quality and CEO/CFO turnover' reviews empirical research that examines whether the managerial labor market is efficient in penalizing culpable managers for financial reporting manipulation. 'Managerial characteristics and their impact on the properties of accounting information' reviews emerging research on the impact of managerial overconfidence on financial reporting properties such as the issuance and accuracy of management earnings forecasts and managerial proclivity to engage in fraudulent activities. 'CEO/CFO gender and variations in financial reporting quality' reviews CEO/CFO gender-based empirical research. The final section of the paper discusses the implications of the studies reviewed herein and presents our conclusions.

Financial reporting quality and CEO/CFO turnover

In an agency theory framework, managers act as agents of the shareholders (principals) and are expected to utilize shareholders' funds in the most efficient way possible. However, not all managers are competent to do so, and the existence of an efficient managerial labor market ensures that poor performers are punished. The threat of termination can give managers an incentive to be cognizant of the shareholder value maximization ethos. Turnover can also facilitate a better match between firms and CEOs based on certain characteristic such as CEO leadership qualities, risk preferences, or expertise in the firm's production technology (Gibson, 2003). Much of the early empirical literature on the association between firm performance and CEO turnover is surveyed by Murphy