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Real earnings management in innovative firms: Does CEO profile make a difference?

Amel Kouaib [a,*], Anis Jarboui [b]

[a] Finance and Accounting Methods, Faculty of Economics and Management, Department of Accounting, University of Sfax, Sfax, Tunisia
[b] Finance and Accounting Methods, Higher Institute of Business Administration, Department of Finance, University of Sfax, Sfax, Tunisia

GRAPHICAL ABSTRACT

More innovative firms

CEO profile:

Behavioral bias (Overconfidence)

Demographic traits (Experience, Education)

Real-based earnings management

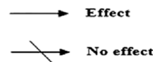
Less innovative firms

CEO profile:

Behavioral bias (Overconfidence)

Demographic traits (Experience, Education)

Real-based earnings management



HIGHLIGHTS

- We examine the relationship between CEO profile and real earnings management in European innovative firms.
- Real earnings management is measured by the index of Cohen et al. (2008).
- Managerial psychological and demographical traits are positively and strongly associated with REM in the more innovative firms.
- Leaders' personal characteristics motivate them to focus on the short-term.

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ABSTRACT

The purpose of this paper is to determine and test the effect of CEO profile including behavioral biases and demographic traits on the level of real-based earnings management (REM) in European innovative firms. Drawing on the literature on behavioral theories of leadership, neoclassical agency theory, prospect theory and signal theory, literature is developed, and hypotheses are generated, regarding CEOs attitudes toward manipulations and innovations. Data from a sample of 190 European firms and 460 CEOs spanning the years 2000–2014 are used to test the model using panel data and multiple regression. We split the total sample in two sub-samples according to the R&D intensity. Firms with high R&D intensity are considered

* Correspondence to:, Faculty of Economic Sciences and Management of Sfax, Airport road, Km4, Sfax, 3018, Tunisia.
E-mail address: amelkouaib@hotmail.fr (A. Kouaib).

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more innovative. Not surprisingly, we find that managerial psychological and demographical traits are positively and strongly associated with REM in more innovative firms.

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1. Introduction

Behavioral theories of leadership are based on the belief that great leaders are made, not born. According to those theories, people can learn to become leaders through training and observation (Charry, 2012). For behavioral theorists, a leader's behavior is the best predictor of his leadership influences and as a result, is the best determinant of his or her leadership success. This behavior-focused approach provides real marketing potential, as behaviors can be conditioned in a manner that one can have a specific response to specific stimuli. Thus, the upper echelons theory shows that the leader can influence the firm's value creation by his personal characteristics and specific skills (Hambrick and Mason, 1984). Therefore, the firm success becomes a reflection of the manager competence (Donaldson and Davis, 1991). This brings us to the logical evidence for the resource dependence theory (Pfeffer, 1981). The power comes back to the actors who make an indispensable resource for the organization operation and which are not easily replaceable. So, firm will be defined as a knowledge accumulation entity guided by the leader's vision. Donaldson and Davis (1991) argue that leaders especially need to have a freedom margin to provide all the functions in their intrinsic motivation that enables them to make effective decisions.

A recent literature in corporate finance examines how psychological biases and managers' characteristics influence on firm decisions (Bertrand and Schoar, 2003; Habib and Hossain, 2013). Hambrick and Mason (1984) suggest that visible demographic traits of top executives could be used to infer their basic beliefs and values and that these conviction systems could influence firm level strategic decisions. The implications of behavior biases such as overconfidence for financial markets (Malmendier and Tate, 2005, 2008; Hribar and Yang, 2010; Malmendier et al., 2011; Schrand and Zechman, 2012; Libby and Rennekamp, 2012; Graham et al., 2013; Zeidan and Müllner, 2015) and innovation strategy (Hirshleifer et al., 2012; Ben-David et al., 2013) are broadly investigated. While, few theoretical researches look at the effects of overconfidence on real manipulations.

Graham et al. (2005) find evidence that managers take real economic actions to maintain accounting appearances. In our knowledge, the influence of top-manager's behavioral and demographic traits on real manipulations in European context still not fully understood. It would be worthy to investigate such a relation since that CEO profile matters more among innovative firms and has the major impact on innovation strategies (Barker and Mueller, 2002; Hirshleifer et al., 2012). The presence of these managerial biases are bringing us to the questioning of their impact on the undertaken actions that change the timing or structuring of an operation, investment and/or financing transaction with a desire to influence the output of the accounting system and mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations.

This research seeks to analyze the relationship between the leader's profile and the real earnings management (REM) of innovative firms. To meet the research objective, the establishment of two samples, as if the firms are innovative (more) or not (less), is required. The first sample is defined as a test sample and the second sample as a control sample. Our sample selection is done with reference to an important criterion namely the definition and design of the innovative firm. Firms that invest heavily in R&D are more likely to be competitive based on the level of innovation and technology (O'Brien, 2003). European Innovation Scoreboard (EIS) views R&D as an innovation input, so we adopt the innovation input (R&D) as a sign of innovative firms. We estimate that companies with a high potential for innovation are most involved in the results management process. We select a total sample and split it in two sub-samples according to the R&D intensity since that firms with high R&D intensity are considered more innovative (Daunfeldt et al., 2015). Therefore, firms are classified according to what they have high or low innovation potential. Firms are then classified into two groups: test sample (more innovative firms with high innovation intensity) and control sample (less innovative firms with low innovation intensity). Given the unavailability of data on R&D expenditure for large period, which is a selection criterion of our sample and for the reason to test our hypotheses on a large sample, we chose the context of European Union. Shifting focus from American context might provide a starkly different understanding of the phenomenon and it can be justified by the fact that European policy is more and more increasingly in favor of R&D investment. With respect to REM, we find a positive association between REM index and CEO profile. In order to increase our confidence in the results and their interpretation, we extend our empirical analyses by two robustness tests. First, we re-run the regression after eliminating observations from dominated countries. Second, we test each overconfidence level lonely (overconfidence at the firm level and at a specific executive at the firm) to check for the robustness of our composite score. We find that our results are unaffected and our hypotheses still verified. We believe the paper provides novel evidence on the link between CEO personnel biases and REM in innovative European firms. It extends the broadly available real manipulations and behavioral finance literature.

The remainder of this paper is structured as follows: Section 2 provides the literature review and hypotheses. Section 3 presents the methodology used. Section 4 reports the empirical results and the robustness checks. Section 5 concludes.

2. Related literature and hypotheses development

2.1. *What is real-based earnings management?*

The financial and accounting literature focuses on the leader profile and its impact on value creation. The study of this relationship is mainly noticed by the accounting choices adopted by leaders (uses of accruals, estimates, and accounting policies). In this sense, the leaders could use their maneuver margin to influence the firm's value. Though than abundant, literature carries, in general, on the issue of accruals-based earnings management to the detriment of the other modality of earnings management called real that have a direct influence on cash-flow.

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