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The moderating effect of CEO profile on the link between cutting R&D expenditures and targeting to meet/beat earnings benchmarks

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ABSTRACT

"*Anybody can manage short, anybody can manage long, balancing those two things is what management is*" (Jack Welch, Ex General Electric CEO). Drawing from a broad theoretical base, this article emphasizes the relationship of CEO traits with real-based earnings management through discretionary R&D expenses and targeting to meet or just beat earnings benchmarks. The analysis is based on a sample of European firms listed on Stoxx Europe 600 index spanning the years 2000–2014. Evidence reveals that (i) achieving earnings targets, (ii) CEO overconfidence, (iii) CEO tenure, (iv) CEO age, and (v) CEO education are significantly associated with cutting R&D expenditures. Findings suggest also that (vi) when firms use abnormal discretionary expenditure as method of earnings management to meet/beat earnings benchmarks, the CEO profile is a moderator variable in a such relation.

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/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. It emphasizes leader's specificity whose own skills are determinants of value creation. 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. Thus, firm will be defined as a knowledge accumulation entity guided by the leaders' vision. The concept of managerial discretion, however, goes beyond the opportunistic dimension, a key element of the transaction costs theory (Charreaux, 1996). 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 especially in terms of technological innovation. The fact that we observe the growing rise of the knowledge-based economy in recent decades where innovation is critical to the firms'

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future success, intangible investments are considered as fundamental determinant of the firm value. Faced with requirements of the new economy, firms are investing more and more in innovation and in value creation activities (Wu et al., 2008; Atalay et al., 2013). The innovation measurement as well as the evaluation of its impact on the economic activity, is likely to result in improved efficiency of resources allocation. It is clear that investment in intangible assets is growing faster than in tangible assets and its valuation is becoming a serious economic issue (Black et al., 2006). Investment in intangible generates on the one hand information asymmetry situations. In particular, investment projects in R&D involve very high costs of development as of control. It is an expensive investment for an uncertain profitability. In case of unsatisfactory performance, some investors prefer the liquidity rather than commitment, what constitutes an obstacle facing the innovation financing (Hansen and Hill, 1991). On the other hand, it poses huge problems especially in terms of R&D accounting. If the activation of R&D investment is a favorable signal of the firm's commitment, so the market will interpret this information as dangerous for the innovative firms. Similarly, placing such expenditures as charge causes deterioration of margin ratios and sets these investments as ephemeral. The last argument is relative to the CEO decision that is related to the investment strategies. Such decision can make the replacement of the manager costlier and increases at the same time his discretionary authority (Shleifer and Vishny, 1989).

Moreover, leaders are also able to promote certain investments over others, depending on their preference and their risks. They will look in particular to undertake projects with short-time recovery as well as with less risky strategies to be in conformity with shareholders' interests (Charreaux, 1991).

This leads us to pose the following questions:

1. Is the desire to achieve a certain earnings' threshold changes R&D-investment decision?
2. Do managerial characteristics strengthen the arbitration between the short- and the long-term?

Most theoretical and empirical studies recognize that investments in innovation are key drivers of firm performance. Thornhill (2006) shows that, the interaction between innovation and knowledge significantly improves the financial performance of the firm. However, the leader, because of its central position within the firm, is able to develop specific knowledge and build a close relationship with the specific human capital in order to make his dismissal increasingly difficult seen its dependency to specific investment projects already undertaken such as investment in R&D. His aim is to demonstrate to stakeholders that he constitutes an indispensable player in the firm. So, investment in R&D can be considered as tools of managerial entrenchment. Then, leaders can develop a supportive relationship network to enhance their prestige and their brand image.

From an accounting side, all listed firms in European Union, since 2005, have been obliged to prepare their consolidated reports in compliance with the International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS). Consequently, firms have to capitalize R&D expenditures according to IAS 38 "intangible assets". The obligation of capitalization of R&D expenses relies on simultaneous conditions cited in § 57 of this standard. Differences between local standards and IAS/IFRS standards can leave flexibility in the hands of the managers. For example, French GAAP and Italian standards differ from IAS. They do not require the capitalization of R&D expenses when certain conditions are satisfied (Markarian et al., 2008). A greater part of studies paying attention on the relevance side of accounting decision about R&D expenses (capitalization), while few ones have focused on the reliability side and more specifically the adjustment of R&D expenses as a means of earnings management. Graham et al. (2005) find evidence that managers take real economic actions to maintain accounting appearances. Aiming to create a relationship between the behavioral and possible real manipulations, we have thought of studying R&D adjustment. R&D investment is the most investment weighing on the firm profitability and minimizing its cost may be the origin of real manipulations that have a direct influence on cash flow.

Roychowdhury (2006, p. 337) defines real earnings management (REM) as:

> *"Departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations".*

Gunny (2010, p. 855) defines REM as:

> *"… when managers undertake actions that changes the timing or structuring of an operation, investment and/or financing transaction in an effort to influence the output of the accounting system".*

The use of this method of shifting earnings, as a departure from optimal operational decisions, appears to be increasingly common for managers attempting to meet earnings benchmarks and is unlikely to increase firms' long-term value (Graham et al., 2005; Roychowdhury, 2006; Cohen et al., 2008). Roychowdhury (2006)'s work considers three types of real earnings manipulation that would increase bottom-line earnings namely: sales manipulation, overproduction and reduction of discretionary expenditures. Our approach is essentially based on the central role of the CEO in the conception and implementation of tools to increase real-based earnings through decision choices on R&D expenditure.

Prior literature attributes earnings management to economic incentives to improve the appearance of company performance or to reach important earnings thresholds, such as targeting to meet or just beat zero earnings, last year earnings and analyst forecasts earnings (Dechow and Sloan, 1991; Baber et al., 1991; Bushee, 1998; Graham et al., 2005; Roychowdhury, 2006; Gunny, 2010; Zang, 2012). Managers candidly admit that they would take real actions such as accelerating the timing of sales, reporting lower cost of goods sold or lessening discretionary expenses, e.g., R&D expenditure, to meet earnings benchmarks. To our knowledge, such unambiguous managerial intent guided by psychological and behavioral traits to destroy short-term firm performance in order to meet financial reporting goals through undertaking real economic actions has not been previously documented. The

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