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Does managerial ability influence the quality of financial reporting?

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ABSTRACT

The purpose of this paper is to study the influence of managerial ability on the quality of their financial reporting. Using a large bank sample from nine different countries and for the time period 2004–2010, we expect that bank earnings quality and accounting conservatism increase with more able managers that disclose more accurate earnings and who report higher information about banks' future earnings and cash flows.

The results confirm that managerial abilities play a significant role in the quality of financial reporting in banks, and that capable bank managers are less likely to manage earnings opportunistically. This study is timely and relevant given the recent emphasis on earnings quality of banks over the last few years, and the criticisms of managerial abilities after the financial crisis. The evidence from this study can help standard-setters and regulators to better understand the business practices and accounting behavior of banks in the light of managerial abilities.

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1. Introduction

Do we know the factors that affect quality reporting in banks? Previous literature on financial reporting quality has mainly focused on the influence of governance characteristics of non-financial firms (Beekes, Pope, & Young, 2004; García Lara, García Osma, & Penalva, 2009). Several other studies have shown the association between financial reporting quality of non-financial firms and several management variables, such as CEO attributes (Francis, Huang, Rajgopal, & Zang, 2008; Koh, 2011), executive overconfidence (Schrand and Zechman 2009), and financial expertise (Matsunaga & Yeung, 2008). According to these studies, managers play a key role in the financial reporting process and exert a major influence on earnings through their operating decisions (Choi, Han, Jung, & Kang, 2015). These results are supported by the upper echelons theory, where managers are not effectively interchangeable, and idiosyncratic differences in personal values and cognitive styles can lead them to make different choices, particularly in complex situations (Bamber, Jiang, & Wang, 2010). These managerial abilities (MAs) are even more relevant in the bank industry due to the large informational asymmetries, opaqueness, and complexities of this sector (Levine, 2004).

Despite the relevance of managerial ability, most of the previous literature has largely ignored the consequences of managerial skills on financial firms. However, banks have larger informational asymmetries and a different capital structure than non-financial firms. Managers in banks face superior complexity arising from many types of risks – credit risk, interest rate risk, prepayment risk, exchange rate risk, liquidity risk, among others (Craig Nichols, Wahlen, & Wieland, 2009). According to Bamber et al. (2010), in complex and ambiguous situations managers operate within the bounds of rationality, and within these bounds their choices can be influenced by their idiosyncratic experiences and values. Therefore, in order to prevent depositors losing confidence in banks and to avoid reputational losses, able managers may have a strong incentive to avoid their earnings becoming negative, which affects their accounting choices. In this regard, and according to Shen and Chih (2005), bank insiders have a high incentive to hide asset substitution behavior through earnings management, because bank assets present bankers with ample opportunities for risk or asset substitution, and their high leverage inclines them to do so. Similarly, Ahmed and Duellman (2013) found that overconfident managers overestimate future returns, leading to a delay in recognition of losses and therefore a reduction in firm-accounting conservatism. On the other hand, able managers can develop specific managerial styles, associated with their personal and educational backgrounds, which promote firm's voluntary disclosure and

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certain conservative characteristics that affect the quality of their reporting (Bamber et al., 2010). These higher-ability managers may also reduce the information asymmetry gap with the markets under financial crisis (Andreou, Philip, & Robejsek, 2015), aiming for higher quality of financial reporting. The more specific the ability entrenched in managers, the more likely it is to be poorly transferrable to other firms and particularly hard for rivals to imitate, so making it a potent source of superior performance (Hatch & Dyer, 2004). Thus, the specific accounting tools that managers may choose to achieve financial reporting goals, such as discretionary accruals or earnings smoothing arising from factors such as their dispositions, personal situations, or previous experiences, can have a positive or a negative effect on accounting choices and hence influence bank financial reporting quality (Ge, Matsumoto, & Zhang, 2011).

Taking into account the relevance of managerial idiosyncrasies and noting the problems of previous measures used to capture the effect of managerial ability (e.g., tenure or education), Demerjian, Lev, and McVay (2012) constructed a broad managerial ability score that outperforms previous ability measures by estimating how efficiently managers use their firms' resources, relative to their industry peers. This measure focuses on the overall managerial effect rather than on specific managerial characteristics (e.g., reputation). Since the publication of their study, some papers have emerged to use this score and investigate the influence of the managerial team ability on several corporate outcomes such as dividend policy (Jiraporn, Leelalai, & Tong, 2015), liquidity creation, and risk taking (Andreou et al., 2015) or the quality of the judgments and estimates used to form earnings in non-financial firms (Demerjian, Lev, Lewis, & McVay, 2013). Given the specificity of financial firms, we cannot infer from these studies whether managerial abilities affect financial reporting quality in banks. Moreover, given the importance to national and global economies of banks, intense information asymmetries, and the recent concern about the quality of reported earnings after the financial crisis, a study of managerial influences on financial reporting quality in the banking industry is clearly needed.

Our main objective is to study the influence of managerial ability on the quality of bank financial reporting. Using a large sample of banks from nine different countries, we expect that bank earnings quality increases with able managers that report less noisy or more accurate earnings, and who take reporting actions that reveal information about banks' future earnings and cash flows. We also hypothesize that more capable bank managers are less likely to withhold information on expected losses, leading to more conservative financial reporting. We build our hypotheses under the upper echelons and the resource-based view theories which suggest that managers' attributes influence how they measure and interpret their situations and therefore have consequences on their decisions (Hambrick, 2007; Holcomb, Holmes, & Connely, 2009). We follow Demerjian et al. (2012) measure as a proxy of managerial ability adjusted to be bank-specific environment and use earnings quality and accounting conservatism as financial reporting quality proxies. Our measure of earnings quality is based on earnings persistence as well as the ability of banks' current earnings to predict their future cash flow (Kanagaretnam, Lim, & Lobo, 2014). Models for testing accounting conservatism are based on aggregate earnings, following Ball and Shivakumar (2005) and Kanagaretnam et al. (2014). Our evidence indicates that after controlling for the bank- and country-specific institutional factors, managerial abilities are important determinants of earnings quality and accounting conservatism in banks. We obtain similar evidence by using alternative measures, such as loan loss provisions (LLPs) and loan loss allowance (LLA).

This study makes several contributions to the literature. First, it extends previous research on managerial ability (Demerjian et al., 2013) by noting that more able managers in banks contribute to better earnings quality and higher conservatism. Second, this is the first empirical study to investigate this association in the international financial industry, which contributes to the calls for further analysis of how country-level institutional systems influence a variety of interest group-level phenomena. The selection of the sample allows us to work with a wide representation of different investor protection levels and bank regulation systems, and broadens our analysis to a wider basis than the Anglo-Saxon area to which most previous research is limited. Therefore, the international sample led us to understand to what extent the consequences of the ability of managers in banks can be generalized in a framework where there are differences in legal tradition, legal enforcement, and bank regulation.

Additionally, focusing on a relatively homogeneous industry facilitates determinants of cross-sectional differences in properties of earnings and enhances the reliability of the inferences from the empirical analyses. Studies on financial firms are also interesting due to the high levels of performance obtained by financial institutions over the last few years, and the consequent opportunities and incentives for managers to earn quasi-rents by distorting earnings. Third, this study contributes to the literature on earnings quality and accounting conservatism, which is mainly focused on the effects of board and firm characteristics (Beekes et al., 2004; Ahmed & Duellman, 2007; García Lara et al., 2009). We extend this line of research by shedding light on managers' abilities to protect shareholder interests and thereby increase accounting conservatism and earnings quality in banks. Thus, this research extends the literature by focusing not on any single aspect of managerial characteristics (e.g., expertise or reputation) but also on the manager's effect in general. Fourth, the study adds to the literature on accounting conservatism in banks (Gebhardt & Novotny-Farkas, 2011; Leventis, Dimitropoulos, & Owusu-Ansah, 2013). While these studies investigate a single-country setting, our international setting allows us to explore the accounting quality effect of managerial abilities with institutional factors. Finally, the paper also contributes to the ethics literature by highlighting the benefits of managerial abilities in upholding the quality of financial reporting.

2. Background and hypotheses

The literature on economics and finance has recently started to explore whether individual managers impose an idiosyncratic influence on corporate decisions (Bamber et al., 2010). One of the first works in this area was by Bertrand and Schoar (2003), who found that managers develop unique individual-specific styles in operational and financing decisions. After this paper, Jensen and Zajac (2004) confirmed that managers develop strategies in line with their own functional experience, and Malmendier and Nagel (2011) reported that managers who experienced lower stock returns during their investing lives were more conservative, so confirming the effect of manager age on corporate decisions. In the same line, Ge et al. (2011) found that accounting choices are influenced by CFOs' individual characteristics arising from their personal situations and experiences.

One of the theories that stresses the importance of managers is the resource-based view theory (Holcomb et al., 2009). According to this theory, managers' ability to effectively use firm resources is itself a valuable resource with potential for generating continual

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