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A Conceptual Review on the Relationship Between CEO Characteristics and Real Earnings Management

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ABSTRACT

This study aimed to review existing literatures related to different characteristics of chief executive officers (CEOs) and real earnings management (REM) to explore from the findings on, whether CEO characteristics influence manipulation of reported earnings. The focus on CEO was due to their uniqueness and significant roles played in the corporate affairs, and reporting process that claimed as paramount in the company. Although, previous studies on the relationship between CEO characteristics and REM have reported mixed and inconsistent results. Similarly, CEOs' personal characteristics that influence the firm's earnings quality were highlighted in the previous studies, which presents an avenue to conduct future robust empirical analysis in the related area. This study provides some recommendations and framework for future academic research related to CEO characteristics and REM. The methodology used in this study was a review process from online peer-reviewed articles in journals and conferences that examines any of the CEO characteristics (education and political affiliation) and REM, earnings quality, or financial reporting quality (FRQ). This study provides an insight based on the review and finds mixed results. Some studies revealed that CEO education and political affiliation tend to influence REM practice while others present inconclusive results.

1. INTRODUCTION

Earnings management practices have cost so much to investors, regulators, and other stakeholders.The technique has threatened the global economic growth and development, and the practice has lessened the quality of financial information, which is the major source relied upon for investors to judge the firm present and future performance (Healy & Wahley, 1999).Studies on earnings management have indicated an increase in real activities manipulation (Li *et al*., 2016; Zang, 2012). According to Roychwdhury (2006), real activities manipulation involves departure from normal activity process that has a direct effect on the firm market value.

Accordingly, real earnings management (REM) affects the firm's cash flow, and accounting scholars such as Roychowdhury (2006), Dechow and Skinner (2000), and Healy and Wahley (1999), revealed that alteration in shipment schedules, delay of maintenance expenditure, acceleration of sales, increase in production, delay in research and development expenses are the typical examples of REM techniques that are available to managers. Roychowdhury (2006) affirmed that sales manipulation, over production, and reduction in discretionary expenditures (R&D, advertisement, and maintenance) activities can be detected from abnormal cash flow operations, abnormal production costs, and abnormal discretionary expenses, respectively.

The role of Chief Executive Officers (CEOs) in managing the shareholders resources would not be underestimated. They are managers sitting at the top hierarchy of firms' management and assisting the firm to vigorously track opportunities (Song *et al*., 2017), regulate the structures and policies as well as protect the interest of investors (Aguinis *et al*., 2018; Edwin & Benjamin, 2017).Therefore, one of the significant roles of the CEOs' is to ensure the firm's financial statement conveys credible and reliable information that can attract and convince different user group; hence, it is the primary source of information about the firm's financial position, performance, and changes to these group of users in making their economic decision (Ifeanyichukwu & Ohaka, 2019).

The trust given to CEOs by shareholders in managing the resource of the firm has revealed some accounting and financial information failures, frauds and scandals as has been witnessed in the case of Enron, WorldCom, Satyam, Tesco, Toshiba, Parmalat, and Lehman Brothers, among others which have caused an incredible loss of wealth, tarnished public trust and global recession (Ebrahim, 2007; Hutchinson *et al*., 2008; Roy, 2015; Charles & McSweeney, 2020).These events have made investors to lose confidence, and consequently raised concern on the trust given to CEOs' in protecting and promoting investors interest, and the credibility and reliability of financial information (Awolowo *et al*., 2018).

Though, earnings management (EM) has become a research subject worldwide and has been extensively studied. Healy and Wahlen (1999)posits that EM is an alteration or exploitation by the insider community of business economic operations with the intention of either manipulating contractual results or misleading those stakeholders. Accounting researchers thus, have different perspectives on the control of earnings, but the novelty of the EM accounting researchers was the studies of: DeFond and Jiambalvo (1994), Healy and Wahlen (1999), Baker *et al*. (2009) who asserted that firm executives are motivated to manage company earnings information for different number of reasons, although manipulating the firm value to mislead stakeholders is improper, but improving the quality of financial reporting is one of the objectives that must be achieved. Similarly, Burgstahler and Dichev (1997) and Degeorge *et al*., (1999) reveals that manipulation of earnings is a policy practiced by the company CEOs to intentionally change accounting figures but should not be referred as illegal operations (Xie *et al*., 2003).

Consequently, previous studies discloses that managers managed earnings at their discretion through accrual-based or real activities manipulation (Chandren, 2016; Zang, 2012; Gunny, 2010; Cohen & Zarowin, 2010; Cohen *et al*., 2008; Roychowdhury, 2006). Accrual-based earnings manipulation (AEM) has been the primary EM technique (Bouaziz, 2020), which refer to as deliberate change in the firm's accounting policies adopted in preparing the financial statement (Sani *et al*., 2020). For instance, changes in provision of bad or doubtful debt, changes in depreciation method or delaying asset write-offs which aimed to mislead the shareholders (Zang, 2012).

Real earnings management (REM) on the other hand, refers to management departures from normal operational practices, purposely to deceive shareholders that the financial statement has been met using the normal operational practice(Roychowdhury, 2006). These consist of decrease in discretionary expenses and offering price discount with the aims of beating an earning threshold. Recent studies show that managers are increasingly manipulating real activities EM to boost their earnings since auditors and regulators find it difficult to detect (Cohen *et al*., 2008; Cohen & Zarowin, 2010).

Therefore, evidence has now shown that corporate managers shifted from AEM to real activities manipulation, which is more difficult to detect (Cohen *et al*., 2008; Roychowdhury, 2006). Cohen and Zarowin (2010) describes REM as "actions taken by managers to move away from normal business practices." Managers are involved in operating activities that adjust to increase the short-term profits of the company at the expense of long-term results. These include abnormal production to reduce cost per unit and raise the sales level by providing favorable credit terms and lessen the budgetary expenses with the purposes of adjusting the earnings figures, and the timing of cash flow (Roychowdhury, 2006). In addition, this study finds that little consideration has been paid to the managers involvement in REM, which has been discovered as difficult. Most of the studies investigate managerial discretion over research and development (R&D) expenses (Dechow & Sloan 1991; Bushee 1998; Cheng & Warfield, 2005). Roychowdhury (2006) suggests that there are series of manipulation activities beyond decrease in R&D expenses adopt by managers.

This study is aimed to provide a comprehensive review of the existing literatures on the association between CEO characteristics and REM. This review would at least make three contributions. First, the study reviews extant measures of different CEO characteristics and earnings management. In addition, emphasis have been given on CEO education, political affiliation, and REM. Secondly, the study would combine empirical results and identify the possible effects of the CEO education and political affiliation on REM. In achieving this objective, the study explains the consistent results and identify any reason for other possible inconsistencies for future studies. Finally, a framework for future studies would be developed to explore on the CEO characteristics and REM.

2. LITERATURE REVIEW

2.1 Real Earnings Management (REM)

The concept of REM was first introduced by Shipper (1989) in the EM studies. Janin (2000) notes that REM comprise real business activities manipulation that has a major effect on the operating cash flows. Similarly, REM was described by Ewert and Wagenhofer (2005) as "changes in the timing or structuring of real business transactions to modify earnings". The most recent concept was that of Roychowdhury (2006), describes REM as moving from normal operating practices, motivated by the intention of managers to deceive certain stakeholders, to assume that certain goals of financial information have been achieved in the normal course of operations. These trends do not ultimately contribute to firm value, even though they help executives to achieve their reporting objective (Dechow *et al*., 2010).

Extensively, studies on the likely intervention of firm managers engagement in the process of preparing firm's financial reporting was discussed not only through accounting estimates and techniques, but also through operational decisions. Roychodhury (2006), Dechow and Skinner (2000), and Healy and Wahlen (1999) reveals that modification in earnings schedules, delaying of R&D and maintenance cost, and sales acceleration are part of managers available techniques of earnings manipulation.

Recently, studies reported that businesses under different reasons have moved their EM practices from AEM to REM, due to some changes in the regulation (e.g., Sarbanes-Oxley Act) that limit the use of AEM (Zang, 2012; Chen *et al*., 2011; Cohen *et al*., 2008), and tighter accounting standards and the adoption of international financial reporting standard (IFRS) (Hlel *et al*., 2020; Ipino & Parbonetti, 2017; Ferentinou & Anagnostopoulou, 2016).

REM can be described to as a shift in the timing or construction of management decisions (the decisions of the company's real operations that are linked with operating, investing, or financing activities), which have a direct effect on cash flows and earnings, motivated by the objective of managers to deceive stakeholders into the real business activities of the company. Therefore, empirical studies have identified three forms of REM which comprises operating, investing, and financing activities (Xu *et al*., 2007; Sellami, 2015). Accordingly, reduction of discretionary expenses, such as R&D, selling, general and administration expenses, and advertisement expenses are other techniques used by CEOs towards the end of their tenure to reduce reported earnings (Dechow & Sloan, 1991). In addition, managers are partly finance repurchased by reducing R&D expenses (Bens *et al*., 2002), and usually reduce discretionary expenses so that to avoid losses on the reported earnings, or to dodge analyst forecast of earnings losses (Roychowdhury, 2006).

Although, earnings management might be summarized from its diverse definitions with some alternative views by classifying them as white, grey, and black (Ronen & Yaari, 2008). Earnings management is said to be beneficial (white) if the transparency of financial reports is enhanced; if the manipulation of the reported information is within the boundaries of confluence with standards is considered as grey, which could be the opportunistic of efficiency enhancement, and malicious if it involves absolute misrepresentation and fraud (Ronen & Yaari, 2008). In addition, they also assert that earnings management can be useful if it signals long-term value, neutral if it discloses the true short-term value performance, and malicious if it hides short or long-term firm value.

Despite studies on REM and CEO characteristics for a series of corporate activities and decision results examined by several studies (Hiebl, 2014; Kouab & Jaboui, 2016; Che-Ahmad *et al*., 2020; Bouaziz, 2020), this research tends to explore more findings on the association between CEO education and political affiliation on REM.The reason for considering on the CEO's education is that it may cause managers to be more attentive to R&D expenditure, which is linked to innovative behavior. According to Hamrick and Mason (1984), educated CEOs have more intellectual complexity since their educational background offers a foundation for their knowledge and skills. On the other hand, political affiliation allows businesses to reap incentives, such as easy access to capital, tax exemptions, and preferential treatment when it comes to policy formulation that benefits the economy (Faccio *et al*., 2006; Agrawal & Knoeber, 2001). This shows that political connection is related with low earnings quality because it provides managers the incentive to manipulate reported earnings and causes negative effect on firm performance (Osazuwa *et al*., 2016; Jaffar & Abdul-Shukor, 2016). Owing to the above reasons, this study will further investigate the effectiveness of CEO education and political affiliation on REM.

2.2 Chief Executive Officer (CEO)

Mostly, the chief executive officers (CEOs) are regarded as being the most powerful individuals in a firm they operate. In a corporate firm, CEO is one of the key players sitting at the top position of firms' management team and can assist the companies to vigorously track opportunities (Song *et al*., 2017)), and regulate the structures and policies of the firm (Aguinis *et al*., 2018; Edwin & Benjamin, 2017). Consequently, Xi *et al*. (2017) report that CEO relationship-focused leadership behaviors relate directly and positively to firm performance in organically-structured firms and indirectly and positively to firm performance in mechanistically-structured firms via the chain-mediating role of employee relations climate and employees' attitudes.

In other term, the firm's success or failure is a significant role that is to be exercise by CEOs. Therefore, studies have revealed that financial accounting and reporting frauds and scandals with CEOs participation had been broadly reported in few years back (Troy *et al*., 2011). Firms' managers are motivated by different techniques of EM to avoid reporting losses on their earnings, which they believe can improve the firms' image. Such method led to upsurge the general perception of EM (Hamid *et al*., 2013), as well as misleading the users understanding of the financial information content (Saleh *et al*., 2005; Malik, 2015).

Miller and Toulouse (1985), and De Vries and Miller (1986) posits that the personality of the CEO is likely to have a major impact on the characteristics of a firm, hence the role of the CEO in the management ladder is critical. In addition, a study reported by Huang *et al*. (2012) show that CEO attributes have a significant effect on the earnings quality of the firm. Many researchers have recently embarked on a significant interest on the effects of managerial characteristics. The studies were interested in exploring the managerial effect on organizational decisions that were predominantly informed by a well-known upper echelon theory founded by Hambrick and Mason's (1984). The theory suggests that the context of management roles, expertise and personalities affects the way corporate managers cope with challenges and issues in their business environment, which in turn affects the firm's outcome (Pham, 2016).

Though, several studies have investigated distinct CEO characteristics on different ways of earnings quality. For instance, CEO financial expertise or accounting background (Kouib *et al*., 2018; Gounopulos & Pham, 2018; Hu *et al*., 2017; Baatwah *et al*., 2015; Jiang *et al*., 2013), CEO tenure (Alhmood *et al*., 2020; Sani *et al*., 2020; Altarawneh *et al*., 2020; Besar *et al*., 2017; Baatwah *et al*., 2015; Ali & Zhang, 2015), CEO career horizon (Abdulmalik *et al*., 2020; Che-Ahmad *et al*., 2020; Li *et al*., 2018), CEO gender (Bouaziz *et al*., 2020; Belot & Serve, 2018; Na & Hong, 2017; Arun *et al*., 2015), CEO duality (Bouaziz *et al*., 2020; Kolias, *et al*., 2019; Yaseer & Al Mamun, 2015; Kamarudin *et al*., 2012). Previous studies have paid less attention on the CEO education and political affiliationon REM. This study reviews related literatures on these variables to see their possible effect from the reported findings and suggest future empirical research on the related area.

2.2.1. CEO Education and real earnings management

Attainment of some education level by industry's personnel is one of the qualifications for an effective management operation. Looking at the significance of education level which is a determinant factor for employees' remuneration and even promotion (Gounopoulos & Pham, 2018). Certo (2003) posits that a good education level is imperative in rising managers' status and will enable them to give out optimal decision. Results from previous studies identified and emphasis on the importance of educational qualification by management staff (Sani *et al*., 2020; Gounopoulos & Pham, 2018; Kouib *et al*., 2018). Some studies were aimed to investigate whether there is a link between the CEOs educational level and the possibility to engage on REM in the firms.

Though, researchers used different proxies for measuring CEOs educational level and its effects on the firms' earnings. Certainly, some previous studies employ proxies such as: PhD/Master certificates acquired, financial/accounting expertise, holding professional certificates in accounting (Sani *et al*., 2020; Qi *et al*., 2018; Gounopoulos & Pham, 2018; Kouaib *et al*., 2018; Li *et al*., 2016; Baatwah *et al*., 2015). For example, Sani *et al*. (2020) measures CEOs education with the proxies of financial expertise. The study reported that there is a significant negative correlation between the financial expertise of the CEO and REM, suggesting that CEOs with financial expertise are minimizing the impact of REM, which is more likely to be used to boost the quality of reported earnings. Qi *et al*. (2018) repeatedly reveals that the educational level of CEOs/CFOs on REM have a significant negative relationship, which in turn increases the quality of financial reporting. Gounopoulos and Pham (2018) report that education for those who have previous employment in banks, investment companies or big audit firms with the use of financial knowledge as CEOs. The result demonstrates that CEOs are less likely to engage on REM. Kouaib *et al*. (2018) explores on the CEOs' accounting-based attributes and EM techniques under mandatory IFRS adoption. The result revealed that accounting-based attributes of CEOs are positively associated with REM due to mandatory adoption of IFRS.

Li *et al*. (2016), on the other hand, reports that managers with a higher accounting education could prevent managerial entrenchment and would prefer REM. Financial knowledge and REM practice of the CEO are negatively associated (Baatwah *et al*., 2015). In the studies of Jiang *et al*. (2013), the result reports that CEO with financial experience offers greater quality of earnings information. In addition, they urge that financial experience should be considered as guiding principles for CEOs to mitigate the level of REM. Compared to managers with no accounting education qualifications, business managers who received some accounting education training engaged less in earnings manipulation (Bamber *et al*., 2010).

Hu *et al*. (2017) investigates whether CEOs with accounting backgrounds have an impact on the EM behavior of companies and the level of conservatism in accounting. The results indicatethat the educational background of the CEOs of the companies had a positive influence on their accounting choices and involvement in REM. Le *et al*. (2020) explored on the impact of the age of CEO and the level of education on REM among the Vietnamese real estate companies listed for the period 2007-2016. The result indicates that possessing higher education level by CEOs is a factor that led to less engagement in EM.

Chiang *et al*. (2016) examines whether senior managers who have professional education certificates participate in EM. Regardless of whether senior managers hold concurrent positions as CEOs and board chairmen, various ways of EM have been used to implement discretionary accruals or manipulate operating cash flows using their professional educational background. The result further shows that the highest degree of EM occurs when managers have dual positions of board chairmen and CEOs. In summary, CEOs with high level of educational background (accounting/

financial experience, accounting literacy, professional qualification, expertise, and previous position held) are more likely to use their skills to mitigate REM.

2.2.2. CEO political affiliation and real earnings management

The political influence of firm is referred to as ties with government officials or politicians who have influence over the decision-making of the business. Influence in this regard applies to political appointments to the board of directors of companies or shareholding (Saeed *et al*., 2015). The proponents of grabbing hand theory, however, suggest that the government attempt to control their interest by extracting the company's resources, as well as by encouraging the appointment of the director, which in turn may influence its value (Wang, 2015). Accordingly, directors that are politically affiliated may have a positive influence on EM (Boubakri *et al*., 2012). It is further reported by Shleifer and Vishny (1994) that political affiliation destroys the value of firm's and reveals low quality of earnings as politicians use their discretion to extract the payment generated by that affiliation.

Political association studies also show that businesses that are politically tied in terms of their earnings quality vary from non-connected firms. The findings on the direction of the effect of the political relation on the quality of earnings, however, are varied. On the one hand, poor penalties and career growth allow executives to politically involve in REM (Chaney *et al*., 2011; You & Du, 2012). Political affiliate managers could use EM to build up their careers, which in turn would help promote them (Leuz & Oberholzer-Gee, 2006).

Therefore, politically affiliated management faces diminutive burden to respond to a high-earnings quality on market demand. More so, studies show that politically affiliated managers prove more positive earnings manipulation than those with no political affiliation (Guedhami *et al*., 2014; Chaney *et al*., 2011). Similarly, You and Du (2012) suggest that top managers that have a political connection are less likely to be dismissed compared to the non-connected counterparts. Al-dhamari and Ismail (2015), and Bliss and Gul (2012) emphasize that higher EM and low earnings quality are associated with politically affiliated firms.

Sadiq and Othman (2017) investigates the relationship between political connection and EM. The study found that politically connected firms are engaged on both AEM and REM, and lack transparency, which in turn, indicates lower earnings quality. A study on the relationship between corporate financial distress and EM with the joint moderating effects of political connection and regional development have been carried out by

Jacoby *et al*. (2019). The findings reveal that political ties weaken the association between financial distress with a little positive EM. Faccio (2006) argues that the main reason for firms to become politically affiliated is their desire to seek for assistance through tax relief and subsidy from government, as well as informal access to loans and contract. In this setting, firm value may be enhanced through political connection. The extant studies found that politically affiliated firms are likely to engaged in REM because they may receive incentives from thegovernment, and thus, their market values may be higher (Ang *et al*., 2013; Faccio *et al*., 2006). Whereas other studies reveal that firms with politically affiliated directors are more likely to have better earnings quality than others without such affiliation (Song *et al*., 2011).

Recent studies reveal that presence of directors who are politically associated is what prevail and increase the CEOs to engage into REM (Sani *et al*., 2020; Chi, Liao & Chen, 2016). However, Li *et al*. (2012) examines the effect of tax-induced earnings management (TEM) from the perspective of political association and reveal that tax rate increased affected only those firmsthat are not politically affiliated. Jiang *et al*. (2018) explores on the role of downward EM and the political connection to the receipt of government subsidies. They discovered that the political link between companies is favorable to securing government subsidies. Ding *et al*. (2018) investigates the effects of government affiliation on the performance of REM among private entities in China. The results indicate that politically connected firms tend to have stronger accounting performance, indicating that politically affiliated firms are more likely participate in REM than non-politicallyconnected firms.Moreover, Braam *et al*. (2015) examines whether the trade-off between real and accrual-based management strategies varies among firms with and without political affiliation. The findings present that firms that are politically affiliated are more likely to substitute REM for AEM compared to non-politically connected firms. Alhmood *et al*. (2020) studies on the effects of CEOs personal characteristics on REM, and the result show that CEOs' political connection was significantly associated with REM in Jordan.

3. METHODOLOGY

Studies on CEO characteristics are of paramount important for the corporate survival, looking at the critical role played by the CEOs, sitting at the highest position of the firm's management team. Going by the significance of this topic, the study examines the extent of the influence of CEO characteristics (education and political affiliation) on REM. In the process of reviewing the related articles, several criteria have been formed to select and review the articles. Similarly, articles that investigate any of the CEO characteristics on either financial reporting quality, REM or earnings quality were selected for this review. Secondly, online peer-reviewed, published journals, dissertations or international conference proceedings and articles were also selected for this review. Thirdly, articles that described the methodology used clearly in the conduct of their studies especially quantitative studies are reviewed. Moreover, quantitative findings on the CEO education and political affiliation on REM are selected as they became significant attributes of this reviewed.

The study search keywords for the relevant literatures were: "CEO characteristics", "CEO attributes", "CEO demographic features", "earnings management", "earnings quality" and "financial reporting quality". The study reviewed 106 research papers from leading accounting, business, finance, and management journals and conferences. In addition, the study articles were searched and ordered according to the CEO characteristics in relation to financial reporting quality proxies (REM). The summary of the review methodology process for this study are presented in Figure 1.

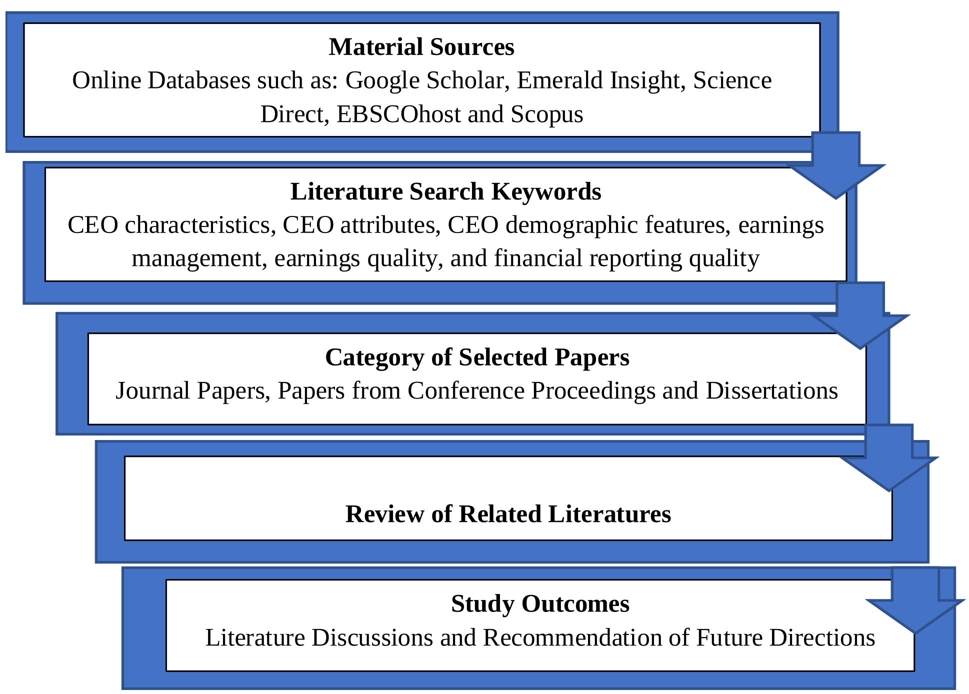

Figure 1: Methodology of the Review Process

DISCUSSION AND CONCLUSION

The main objective of this study is to review empirical research that examineson the relationship between CEO characteristics (education and political affiliation) and REM. Although, on the review process, CEO characteristics and earnings quality, and financial reporting quality were examined, considering that REM is one of their proxy. Consequently, this study is expected to increase the understanding of the concerned groups of users, such as: policymakers, stakeholders, investors, and scholars about the significant roles of CEO attributes in managing the corporate resources entrusted in them. Moreover, the overall outcome of this review shows that the roles of CEO characteristics on the REM should not be underestimated, as it affects the firms' earnings quality.

Based on the related literatures reviewed on CEO characteristics, it is evidenced that CEO financial or accounting education, can determine the firms' earnings quality. Further, it is significant to note that such attributes may positively improve firm's performance and earnings quality, since investors' may find it reliable to make their economic decision. Financial information anomalies may be reduced to the minimal if the CEOs have financial or accounting background. In addition, CEO tenure and career horizon can support the experience and background of the CEO in relation to the accounting choice, alongside enhancing the CEOs' accounting education to avert any financial misconducts.

Though, the result of the reviewed literatures reported mixed findings that are inconsistent. This created a room for further robust analysis especially in developing economy like Nigeria, afterconsidering most of the previous studies were conducted in a developed market.Afterward, suggestion for further analysis on the relationship between CEO education, political affiliation, and other attributes on REM is recommended but the results need to be interpreted in well-organized form.

Besides, this current review is an emphasis on the REM and financial reporting quality, future research may consider the results of this review to emphasis on the empirical effect of CEO characteristics (education and political affiliation) on REM, because of the significance of earnings quality to investors. Some advances have been made in understanding the association between education and political affiliation of the CEO on REM. The outcome will be significant to the body of knowledge, policymakers, practitioners as well as regulators. Apart from the CEO education and political connection, future studies may also consider other CEO characteristics that were not explored in this review, which may have any possible effect on the firm's earning quality, such as CEO ethnicity, CEO religious, CEO ownership, CEO power. Therefore, this study provides some research question that may need further investigation as shown in Table 1.

Table 1
Recommended Research Questions for Future Empirical Studies

No.	*Research Questions*
	CEO Characteristics and Real Earnings Management
RQ1	What is the effect of CEO education on REM?
RQ2	What is the effect of CEO political connection on REM?
	Characteristics and Firm Financial Performance
RQ3	What is the effect of CEO education on firm financial performance?
RQ4	What is the effect of CEO political affiliation on firm financial performance?

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