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Original Article

The Influence of CEO Characteristics Towards Earnings Quality In Indonesian Manufacturing Companies

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Abstract: *This study aims to examine the influence of CEO characteristics towards earnings quality in Indonesian manufacturing companies. This study uses upper echelon theory as a theoretical basis to formulate hypotheses. The sample of this study consists of 46 Indonesian manufacturing companies in 2013-2015, with a total of 138 observations. The data on each CEO's characteristics, namely, the CEO's financial expertise, CEO's educational background, the female CEO, and CEO's age, were hand-collected from the company's annual report. The data on earnings quality is calculated based on the Dechow & Dichev model. The data on earnings quality and control variables were obtained from the BVD Osiris Database. The results of the study show that CEO financial expertise has a positive influence towards earnings quality, while other three characteristics namely CEO, business educational background, female CEO, and CEO age, have no effect towards earnings quality*.

Keywords: *CEO Characteristics, Earnings Quality, Indonesian Manufacturing Companies.*

I. INTRODUCTION

In the accounting research area, financial reporting quality is still become important topic since quality financial reports represent accurate information about firm performance, which is important for decision-making [1]. However, financial report manipulation, in the form of earnings management, that still occurred in recent years, such as earnings management that was conducted by Garuda Indonesia and Wijaya Karya in the Indonesian context, shows that companies are still trying to hide their actual performance in order to maximize their private benefit. In addition, since earnings become an important part of determining firm performance, there is a tendency for companies to increase earnings by conducting earnings management that can reduce earnings quality [2]. Therefore, research about determinants of earnings quality is still important.

According to prior research, factors that influence earnings quality involve the role of Chief Executive Officer (CEO) [3]–[6]. This is because the CEO has an important role that can affect the success or the failure of the company [7]. Specifically, one of the important roles of the CEO is to make strategic decisions that can affect both the company's performance and financial reporting quality. In the context of financial reporting, the CEO has a major influence in determining the information that will be disclosed in the annual report and the style of financial statement disclosure [8], [9]. Furthermore, several cases of financial report manipulation are driven by the CEO's motivation to improve the company's image by avoiding reporting losses or reporting low profits [7]. Based on upper echelon theory, the individual and managerial characteristics of the CEO can influence top management decision-making [10], including decisions in financial reporting. In addition, research in the fields of accounting and management shows that the individual and managerial characteristics of the CEO affect the company's financial reporting quality [11].

This study aims to examine the influence of CEO characteristics towards earnings quality. Specifically, CEO characteristics that are used in this study are CEO financial expertise, CEO business educational background, female CEO, and CEO age. The selection of a CEO with financial expertise was based on the fact that they have a thorough understanding of accounting and financial matters, are more aware of the dangers of falsified financial reports, pay closer attention to and oversee accounting records and internal audits and are more aware of the kinds of information that investors want. As a result, they are expected to improve the quality of earnings [11, 12]. Similar to CEO financial expertise, a CEO with a business educational background is expected to improve earnings quality since they are expected to have a better understanding and concern about financial issues. Furthermore, female CEO is expected to have more ethical behavior, better monitoring ability, effective coordination, and higher organizational commitment compared to male CEO [2], [13], [14]; therefore, companies with female CEOs are expected to have better earnings quality than male CEOs. In addition, CEO age is expected to have a positive effect on earnings quality since CEOs with older age tend to focus on financial stability, choose low-risk decisions, focus on long-term interest and tend to be risk averse [2], [10], [15]. Therefore, a CEO with older age is expected to have better earnings quality.

This study contributes to the literature by providing evidence about the effect of CEO characteristics towards earnings quality in developing countries, namely Indonesia, whereas most previous studies tend to focus on developed countries. Indonesia has unique characteristics with ownership concentration that is dominated by family firms [16]–[19].

II. LITERATURE REVIEW

A) Upper Echelons Theory

Upper echelon theory explains that top management backgrounds such as formal education, socioeconomic background, gender, age, and experience can influence top management's interpretation of problems and how top management makes decisions to solve these problems [10]. Previous studies have found that several individual and managerial characteristics of the CEO influence accounting decisions, especially in terms of accounting reporting that can affect earnings quality. According to previous research, several CEO characteristics that influence earnings quality include CEO financial expertise [8], [11], [12], [20], CEO Age [21], [22], CEO tenure [23, 24], CEO reputation [25], *CEO Networks* [26], *the overconfidence of CEOs* [27] & *CEO Gender* [21], [28].

However, most of these studies still focus on developing countries. Research that examines the relationship between CEO characteristics and earnings quality in the context of developing countries, especially Indonesia, which has unique characteristics, is still limited. Indonesia is dominated by companies that have concentrated ownership structures [16, 17], especially family firms [18], [19]. Therefore, it becomes important to examine whether CEO characteristics can affect earnings quality in the context of companies that have concentrated and family ownership structures that have a powerful influence towards management decisions. CEO characteristics that are used in this research are CEO financial expertise, CEO business educational background, female CEO, and CEO age. The explanation of influence of each CEO characteristic towards earnings quality is explained as follows.

B) The Influence of CEO Financial Expertise towards Earnings Quality

This study examines the influence of CEO financial expertise towards earnings quality. A CEO with financial expertise is a CEO who has experience in finance, banking, investment companies, financial directors, or experience in other financial fields, such as accountants and auditors [11]. CEO financial expertise plays an important role in determining the quality of financial reports. This is due to several things. First, a CEO who has financial expertise has a deep understanding of accounting and financial problems, so he can make accounting policies. Therefore, the quality of financial reports is expected can be improved [11]. Second, CEO who has financial expertise better understand the risks of manipulated financial reports, so they tend to avoid manipulating financial reports to maintain their reputation [11]. Third, a CEO who has financial expertise will pay more attention to accounting records and internal audits [12]. Supervision carried out directly by the CEO can prevent manipulation of accounting records. In this case, although the main responsibility for financial reporting lies with the Chief Financial Officer (CFO), the CEO can still influence the decisions of the CFO. The CEO financial background will facilitate communication between CEO and CFO so that they can work together to establish better accounting policies. Fourth, the experience of a CEO who has financial expertise in the capital market makes the CEO very familiar with the type of information desired by investors, thus encouraging the CEO to provide quality financial reporting.

Previous studies showed that CEOs with financial expertise tend to provide quality financial reporting. Research conducted by [8] found that financial reporting disclosures in companies with CEOs who have accounting and finance backgrounds reflect more conservatively and avoid ambiguous financial reporting disclosures. This means that CEOs want accurate financial reporting that has better earnings quality. Furthermore, research by [20] found that CEOs with financial experience in Chinese companies tend not to engage in real earnings management, therefore improving earnings quality. In addition, research by [12] found that CEOs with financial expertise are positively related to audit report timeliness. Furthermore, CEOs with accounting expertise tend to encourage more strategic decision-making to improve the quality of financial reporting. Therefore, based on the theoretical discussion, research results, and arguments developed in this study, hypothesis 1 is as follows.

H1: CEO financial expertise has a positive influence towards earnings quality in Indonesian manufacturing companies.

C) The Influence of CEO Business Educational Background towards Earnings Quality

CEO educational background become important because a CEO with higher education has the ability to think in a complex way, strong analytical aptitude, and the ability to adopt new ideas that can be implemented effectively [29, 30]; therefore, it can influence firm performance. In relation to earnings quality, CEO education is a factor in determining earnings management that influences earnings quality [31]. According to [8], CEOs with business education backgrounds are likely to disclose accurate information and be more sensitive to the negative effects of manipulated financial reports. Business educational background, especially in accounting, makes CEOs more conservative in financial reporting. Therefore, CEOs with business educational backgrounds tend to adopt accounting methods that are less aggressive in order to avoid misleading information and risks of manipulated financial reports [31]. In addition, a CEO with a business educational background is expected to have a better understanding and concern about financial issues, therefore, it is expected to improve earnings quality.

However, other research about the relationship between CEO educational background and earnings management found that CEOs with higher levels of educational background tend to conduct earnings management, both accrual and real earnings management [2], [31], [32]. For example, research that is conducted by [2] in Indonesian manufacturing companies, argued that CEOs with higher levels of educational background tend to conduct accrual earnings management compared to real earnings management. This is because accrual earnings management requires a complex understanding of accounting standards rather than real earnings management. Consistent with their argument, they found that a CEO's educational background has a positive influence towards accrual earnings management and a negative influence towards real earnings management. Similar to [2], research conducted by [32] also found that higher education level in top management is positively correlated with accrual earnings management and negatively correlated with real earnings management since real earnings management has real cash flow consequences. Furthermore, research conducted by [31] found that CEOs with advanced degrees, especially in accounting, are able to conduct real earnings management effectively rather than accrual earnings management. They argue that business education limits a CEO’s ability to manage earnings through accruals since CEOs with an accounting education background tend to be conservative in accounting standards that are related to accrual earnings management. Therefore, based on conflicting arguments and findings about the relationship between CEO business educational background and earnings quality, hypothesis 2 is stated as follows.

H2: CEO business educational background has a correlation with earnings quality.

D) The Influence of Female CEOs towards Earnings Quality

This study examines the influence of female CEOs towards earnings quality. Gender, which refers to the different behavior between males and females, becomes important in relation to the decision-making process that influences both firm performance and financial reporting quality. In relation to earnings quality, female CEO is expected to have more ethical behavior, better monitoring ability, effective coordination and higher organizational commitment compared to male CEOs [2], [13], [14]. These characteristics encourage female CEOs to promote higher business ethics, therefore reducing earnings management and improving earnings quality. Furthermore, female CEOs can achieve higher earnings without earnings management than male CEOs [2]. Therefore, female CEO are less likely to conduct earnings management because of their ethics and trust [13].

Previous research supports the argument that female CEOs can improve earnings quality. Research that is conducted by [33] found that company with female managers has lower accrual earnings management. They argue that females are more cautious and less aggressive than males in business decision-making. Furthermore, in relation to financial reporting, [33] argues that female managers are more likely to be compliant with accounting regulations. Therefore, companies with female CEOs will have financial reports with high earnings quality. Other research conducted by [2] provides evidence to suggest that female CEOs are less likely to engage in earnings management than male CEOs. Therefore, earnings quality in a company with a female CEO will increase. Based on the theoretical discussion, research results, and arguments developed in this study, hypothesis 3 is stated as follows.

H3: Female CEO has a positive influence towards earnings quality.

E) The Influence of CEO Age towards Earnings Quality

This study argues that CEO age has a positive effect on earnings quality. The argument is that CEOs with older age tend to focus on financial stability, choose low-risk decisions, focus on long-term interest, and tend to be risk averse [2], [10], [15]. The argument is supported by [34] arguing that older individuals have longer exposure to traditional culture, so they are likely to be more ethical. Furthermore, older CEOs believe that high-risk behavior will pose a risk to their retirement; therefore, they are likely to avoid it. In addition, older CEOs are likely to choose unaggressive approaches in business decisions, including decisions in financial reporting. Therefore, older CEOs are less likely to engage in opportunistic behavior in financial reporting, such as earnings management.

Previous research supports the argument that CEO age can improve earnings quality. Research that is conducted by [35] found a positive association between CEO age and earnings quality. They argue that older CEOs get more ethical and more conservative; therefore, they are less likely to engage in earnings management and improve earnings quality. Furthermore, research by [36] found that CEO age has a negative influence towards earnings management that improves earnings quality. They argue that ethical beliefs are related to CEO age; therefore, CEOs with older age tend to be more ethical and less likely to conduct earnings management. Based on the theoretical discussion, research results, and arguments developed in this study, hypothesis 4 is stated as follows.

H4: CEO age has a positive influence towards earnings quality.

III. RESEARCH METHOD

A) Research Design

This research design is quantitative research. This study uses data from manufacturing companies that are listed on the Indonesia Stock Exchange (IDX). The total population is 123 Indonesian manufacturing companies that are listed on the Indonesian Stock Exchange (IDX) from 2013-2015. The sampling technique is purposive sampling. After eliminating companies that did not have complete data on the CEO profile and financial data to measure earnings quality, the sample was 46 companies with a total of 138 firm-year observations. This study used 1 dependent variable, namely earnings quality; 4 independent variables, namely CEO financial expertise, CEO business educational background, female CEO, and CEO age; and 3 variable controls, namely ownership concentration, firm size, and profitability.

B) Method of Collecting Data and Measurement

This research uses archival data that was collected from the annual report and the BVD osiris database. Variable earnings quality was measured based on the model developed by [37]. The additional standard deviation of the regression equation for modifications to previous working capital, present working capital, and future working capital was used in this model to quantify the quality of earnings. In particular, the following is the regression equation.

$$\Delta WCA_t = \alpha_0 + \alpha_1 CFO_{t-1} + \alpha_2 CFO_t + \alpha_3 CFO_{t+1} + e_t$$

Where:

ΔWC_t = Changes of company's working capital accrual in period t,
CFO_{t-1} = Cash flows from the company's operating activities in period t-1,
CFO_t = Cash flows from the company's operating activities in period t-1,
CFO_{t+1} = Cash flows from the company's operating activities in period t+1.

The accrual value that has no relationship with the realization of cash flow is reflected in the residual (e_t) which is calculated through the following equation.

$$e_t = WCA_t – (\alpha_0 + \alpha_1 CFO_{t-1} + \alpha_2 CFO_t + \alpha_3 CFO_{t+1})$$

As a measure of the quality of earnings, the residual standard deviation (accrual) value to the average value was employed. The quality of earnings decreases as the residual standard deviation (accruals) increases. Earnings do not reflect actual conditions when the residual standard deviation is high since it shows a higher accrual deviation. Therefore, lower earnings quality is indicated by a large residual (accrual) standard deviation value. The standard deviation value is transformed by multiplying by minus one in order to make the residual standard deviation (accrual) value more consistent with the dependent variable, which is the caliber of the financial reports.

The data of independent variables, namely CEO financial expertise, CEO business educational background, female CEO, and CEO age, were hand-collected from the company's annual report. In addition, the data of control variables, namely ownership concentration, firm size, and profitability, were obtained from the BVD Osiris database.

C) Data Analysis Techniques

This research uses a partial least square (PLS) approach to test the hypothesis. PLS is used in this study because the results of the data normality test show that the data distribution is not normal. Different from other multivariate techniques, PLS is not dependent on the data distribution normality to test the hypothesis. The research model is shown as follows.

$$EQ= \alpha + \beta 1FINEXP+ \beta 2EDU+ \beta 3FEM+ + \beta 4AGE+ \beta 5OWC+ \beta 6Ln\_SIZE + \beta 7ROE + \mathcal{E}$$

Where:

EQ = Earnings Quality
FINEXP = CEO Financial Expertise
EDU = CEO Business Educational Background
FEM = Female CEO
AGE = CEO Age
OWC = Ownership Concentration
LOG_SIZE = Natural Logarithm of Firm Size
ROE = Return on Equity

III. RESULTS AND DISCUSSION

A) Description of Research Data

The data description of earnings quality (EQ), CEO financial expertise (FINEXP), CEO business educational background (EDU), female CEO (FEM), CEO age (AGE), ownership concentration (OWC), firm size (Ln_Size), and profitability (ROE) is presented in table 1. The earnings quality variable (EQ) has a minimum value of -0.52 and a maximum value of -0.01, as indicated by the data in Table 1. The value of earnings quality was negative. In order to change the trajectory of the accrual value—which is a measure of earnings management—to earnings quality and demonstrate a positive association, this value was calculated by increasing the accrual value that emerged from the Dechow and Dichev approach by -1. The value of each CEO's characteristics shows varying results. The mean value of CEO financial expertise (FINEXP) is 0,3623 which means 36,23% of CEOs in this research sample have financial expertise. Furthermore, the mean value of CEO educational background (EDU) is 0,562, which means 56,2% of CEOs in this research sample have a business educational background. On the other hand, the mean value of female CEOs (FEM) is 0,0432, which means only 4,35% of CEOs in this research sample are female. Finally, the average age of CEOs is 54,88 years. The mean value of ownership concentration is 0,5195, which is consistent with research conducted by [17].

Table 1. Description of Research Variable

Variable	N	Minimum	Maximum	Mean	Standard Deviation
EQ	138	-0,52	-0,01	-0,0865	0,08070
FINEXP	138	0,00	1,00	0,3623	0,48242
EDU	138	0,00	1,00	0,5652	0,49753
FEM	138	0,00	1,00	0,0435	0,20467
AGE	138	39,00	86,00	54,8841	8,86646
OWC	138	0,10	0,95	0,5195	0,24018
LOG_SIZE	138	9,66	15,75	12,6796	1,26077
ROE	138	-0,88	1,26	0,0917	0,23886

B) Hypothesis Testing

The result of hypothesis testing is presented in Table 2. Table 2 shows that the variables of CEO financial expertise (FINEXP) are significant (sig. value less than 0,05). Therefore, it can be concluded that hypothesis 1 is supported. However, 3 other independent variables, namely, CEO educational background (EDU), female CEO (FEM), and CEO age (AGE), show insignificant values (sig.value more than 0,05). Therefore, hypotheses 2, 3, and 4 are not supported. One of the control variables, namely ownership concentration (OWC), shows significant values (sig.value less than 0,05), which is consistent with research that is conducted by [38]. In contrast, other variables, namely firm size (LOG_SIZE) and profitability (ROE), show insignificant values (sig.value more than 0,05).

Table 2. The result of PLS Testing

Variable	Path Coefficient	P-Values
FINEXP → EQ	0,410	0,000***
EDU → EQ	0,016	0,874
FEM → EQ	0,013	0,824
AGE → EQ	-0,137	0,106
OWC → EQ	-0,204	0,025**
LOG_SIZE → EQ	0,009	0,868
ROE → EQ	0,007	0,242
Observations	138	
R Square	0,251	
Adjusted R Square	0,210	

C) Discussion

Based on the PLS testing result, it can be concluded that only hypothesis 1 is supported. The result of this study is consistent with previous research [8], [12] [20]. The result of this study is also consistent with upper echelons theory, which explains that individual characteristics of CEO will influence the decision making process, particularly decision-making in financial reporting. CEO with a financial expert background has a deep understanding of accounting and financial issues, better understands the risks of manipulated financial reports, pays more attention and supervision to accounting records and internal audits, and better understands the types of information desired by investors, therefore it expected to improve earnings quality [11-12].

However, the CEO's business educational background has no influence towards earnings quality. The result of this study is not consistent with previous research [2], [31], [32]. This study argues that a CEO's business educational background should have a correlation with earnings quality since a CEO with a business educational background has a better understanding about financial issues. The inconsistent results are likely due to the gap between business education and real experience in the company. Educational background is not enough for a CEO to better understand financial issues. CEOs should have sufficient experience in business and finance to better understand business and financial issues. Furthermore, female CEO has no influence towards earnings quality. The result of this study is not consistent with previous research [2], [33]. This study argues that female CEOs should positively influence earnings quality since female CEO is expected to have more ethical behavior, better monitoring ability, effective coordination and higher organizational commitment compared to male CEO [2], [13], [14]. The inconsistent results are likely due to the small number of female CEOs in Indonesia; therefore, it can't influence earnings quality. Finally, CEO age also has no influence towards earnings quality. This study argues that CEOs with older age tend to focus on financial stability, choose low-risk decisions, focus on long-term interest, and tend to be risk averse [2], [10], [15]; therefore, CEOs with older age should improve earnings quality. The inconsistent results are likely due to the characteristics of Indonesian companies. Indonesia is dominated by companies that have concentrated ownership structures [16-17], especially family firms [18], [19]. According to socioemotional wealth theory, family firms are more committed to protecting the company's reputation by reporting transparent and accountable financial reports. However, socioemotional wealth is most influential in younger family members than older generations of family firms [39].

IV. CONCLUSION

A) Conclusion

This study aims to investigate the influence of CEO characteristics towards earnings quality in Indonesian manufacturing companies. This study uses upper echelon theory as a theoretical basis to formulate hypotheses. According to upper echelon theory, the individual and managerial characteristics of the CEO can influence top management decision-making [10], including decisions in financial reporting. Particularly, individual characteristics of CEOs that are used in this research are CEO financial expertise, CEO business educational background, female CEO, and CEO age. The result of this study shows that only the CEO's financial expertise has a positive influence towards earnings quality, while the other three characteristics namely CEO, business educational background, female CEO, and CEO age, have no effect towards earnings quality.

B) Limitation & Future Research

There are several limitations to this research. First, the data that is used in this study is limited to 2013-2015, and future research can use data from a wider range and recent years to capture better results. Second, the sample that is used is limited to manufacturing companies; therefore, future research may use other company sector. Third, due to data limitation, the sample that is used is only 46 of the total 123 manufacturing companies listed on the IDX in 2013-2015 (less than 50% of the population). Therefore, this may have an impact on the results.

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