

The Effect of Managerial Ability on Financial Reporting Quality: An Empirical Analysis of the Banking Industry

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Abstract. This study aims to examine the effect of managerial ability on financial reporting quality. The samples of this study are listed banks in the Indonesia Stock Exchange during the period of 2010 to 2016. with total observations are 210 firm-years. Managerial ability is measured using Data Envelopment Analysis (DEA). Earnings persistence and earnings predictability are used to measure financial reporting quality. By using panel data regression, the results show that managerial ability has a negative effect on financial reporting quality, for both measures. This may be due to when the manager has higher ability, he/she tends to be opportunistic and take actions (such as opportunistic earnings management) and thus earnings become less persistent as well as less predictable (low financial reporting quality).

Keywords: Banking, Financial Reporting Quality, Managerial Ability.

1. Introduction

Financial statements issued by companies are the results of accounting process and contains many useful financial information about firm performance. especially to external parties. Management is the party with the responsibility for the managing company operations. They also responsible for the preparation of financial statements, so that their ability or skill will affect the quality of the report. Financial statements should be able to provide information about management performance in running the business.

Management as insider always have information advantage over external parties. The presence of this information asymmetry provides opportunity for management to take opportunistic actions to conceal its bad performance by doing earnings management. Managers are the main actors in the companies, and so with better managerial ability it is expected the companies' performance will also be better. Managerial ability should also play an important role in determining financial reporting quality because managers with high managerial ability would have better knowledge of their business and be able to make effective judgments and take appropriate actions, so that it could utilize company resources effectively and ultimately could achieve better company performance (Wang et al., 2017). Managers' ability could also influence financial reporting quality with their attitudes toward internal control and through their role as information channels to directors. other managers. and auditors [1] In other words, managerial ability can affect financial reporting quality.

Garcia-Meca & Garcia-Sanchez [2] examine the effect of managerial ability on financial reporting quality. They find that higher managerial ability able to produce higher bank earnings

quality, which means that managerial ability plays an important role in shaping the financial reporting quality in banks. We extend their research by doing similar study in Indonesia. To the best of our knowledge, there have not been any studies examining the effect of managerial ability on financial reporting quality in the banking sector in Indonesia. Managerial ability is very relevant in the bank industry because of the information asymmetry, opacity and greater complexity in this sector [3]. Banking companies in Indonesia have grown rapidly which are stimulated by the development of information technology. Information technology-based banking innovation has an extraordinary impact on efficiency and effectiveness. Thus, managerial ability is expected to play more significant role in banking industry.

2. Literature Review and Hypotheses Development

According to Jensen and Meckling[4] agency relationship was a contract between manager (agent) and principal, in which there was an authority delegation in decision-making from the principal to the manager. The principal delegate the authority on decision-making to agent (manager) and expects that the manager will take certain actions that are in line with the interests of the principal.

Based on Arkerlof[5], agency theory was characterized by information asymmetry, which are moral hazard and adverse selection. Bouckova[6] suggests that information asymmetry could lead to moral hazard, in which one party with information advantage (i.e. management) exploited the information asymmetry for their own personal benefit. The principal has limitations in controlling agent behavior and can only evaluate manager performance based on reported results in financial report which are prepared by the management.

One theory that emphasizes the important role of managers is resource-based view theory Holcomb[7]. According to this theory, the ability of managers to utilize existing resources is a valuable resource to enhance the company's competitive advantage. The manager's ability is influenced by the accumulation of knowledge gained through education or work experience, which influences his/her ability to make decisions. Another related theory is upper echelons theory which states that the characteristics of each manager influence the ability of managers to analyze the situation so that it will affect the company's performance[8]

Demerjian [9] develop a measure of managerial ability by estimating how efficiently managers use company resources compared to companies in their industries. Further, Demerjian[10] stated that managers with higher ability have more knowledge about business conditions, have more persistent profits, and are more accurate in estimating accruals. They find that companies with high management skills had better quality financial reporting.

Garcia-Meca and Garcia-Sanchez[2] measured financial reporting quality by using three measurements, namely earnings persistence, predictability, and accounting conservatism. The measurements are in line with the earnings attributes[11] by Francis. Earnings persistence represents expected accounting earnings in the future which is reflected in current year earnings. Persistence is one measure of financial reporting quality, where higher persistence indicate a sustainable profit[12]. Earnings persistence is an attribute of earnings quality which shows the company's ability to maintain the current earnings to persist in the future. High earnings persistence is more useful in the decision making process[13]. Another measurement of financial reporting quality is predictability. Predictability is how the current profitability able to predict future operating cash flows[14]. Earnings are said to be unpredictable when earnings is volatile and unpredictable[15] (Graham et al., 2005). Increase earnings predictability can provide useful information as current year earnings can be informative in predicting future earnings.

Managers are important players in companies. so with better managerial capability, it is expected that the companies' performance will be higher. The resource-based view theory argues that the ability of managers to effectively use the company resources are valuable and potential resources to produce certain conservative characteristics that affected reporting quality[16]. The more specific the managers' capabilities which were embedded within them, the more possibilities that they could not be transferred to other companies and they were very difficult to be imitated by competitors. so that this made them a significant sources of high-performance companies[17].

There are several extant studies examining the effect of of managerial ability on financial reporting quality. Wang et al. (2017) argued that more capable managers would have knowledge of their business and could make effective judgments and forecasts so as that they could alter companies' resources better and ultimately they could achieve better business performance. In addition. managers could also affect financial reporting quality with their attitudes toward internal controls and through their role as information channels to directors, other managers, and auditors[1]. Garcia-Meca and Garcia-Sanchez [2] find that managerial ability have significant positive effect on financial reporting quality. Based on the explanations above, the hypothesis is as follows.

H1: There is a positive effect of managerial ability on financial reporting quality.

3. Research Method

The population in this study are listed banks on Indonesia Stock Exchange (IDX) in the period 2010-2016. The sample selection criteria are: (1) bank listed on IDX during 2010-2016; (2) Published financial statements during 2010-2016. The selection of banking sector because banking companies have asymmetric information. opacity. and greater complexity compared to other sectors. so that this selection makes more relevant to research on managerial capability and quality of financial reporting. Based on those sample selection criteria. we have 30 banking companies in each year. with a total of 210 observations.

In this study. the dependent variable is financial reporting quality. Financial reporting quality is closely related to the performance of the company embodied in the company's earnings. Higher earnings quality provides more information about the company's financial performance that is relevant to the decision made by the decision maker. Referring to Garcia-Meca & Garcia-Sanchez[2]. this study measures the quality of earnings by using earnings persistence and predictability.

Earnings persistence is an attribute of earnings that demonstrates a company's ability to retain the amount of profit gained now to the future. Profit persistence can be the basis in the assessment of earnings quality. because high quality profits are more persistent and useful in the decision making process. The model used to measure the profit persistence is as follows.

$$EBT_{it+1} = \varpi_0 + \varpi_1 EBT_{it} + \varpi_2 MA_{it} + \varpi_3 MA_{it} * EBT_{it} + \varpi_4 SIZE_{it} + \varpi_5 SIZE_{it} * EBT_{it} + \varpi_6 DEPOSITS_{it} + \varpi_7 DEPOSITS_{it} * EBT_{it} + \varpi_8 LOANGROWTH_{it} + \varpi_9 LOANGROWTH_{it} * EBT_{it} + YEAR_{it} + \varepsilon_{it}$$

Where:

EBT_{it+1} = earnings before tax scaled by total assets at the beginning of year t
 MA_{it} = managerial ability
 $SIZE_{it}$ = company size (natural logarithm of total assets)
 $DEPOSIT_{it}$ = the amount of deposit scaled by total assets at the beginning of year t
 $LOANGROWTH_{it}$ = the difference between bank credit growth rate and the median of credit growth of all listed banks

In this study, the measurement used for earnings persistence is by looking at the coefficient of current period earnings (EBT_t) or ϖ_1 . Higher coefficient means higher earnings persistence (higher financial reporting quality). Whereas ϖ_3 shows the effect of managerial ability on earnings persistence.

Predictability is also a measurement of financial reporting quality. Predictability is the ability of current profitability to predict future cash flow. This is often used as one measurement of financial reporting quality since investors consider that cash flow as more relevant than profitability, and more useful in the predictability for liquidity and solvency (Garcia-Meca & Garcia-Sanchez, 2017).

$$EBTLLP_{it+1} = \varpi_0 + \varpi_1 EBT_{it} + \varpi_2 MA_{it} + \varpi_3 MA_{it} * EBT_{it} + \varpi_4 SIZE_{it} + \varpi_5 SIZE_{it} * EBT_{it} + \varpi_6 DEPOSITS_{it} + \varpi_7 DEPOSITS_{it} * EBT_{it} + \varpi_8 LOANGROWTH_{it} + \varpi_9 LOANGROWTH_{it} * EBT_{it} + YEAR_{it} + \varepsilon_{it}$$

Where:

EBTLLP_{it+1} is EBT_{it+1} plus loan loss provision year t + 1, scaled by total asset at the beginning of year t

To measure the ability of earning ability in predicting future cash flows or predictability, earnings regression and loan loss provisions are used one period ahead of current period earnings. Previous research in banking had done by using pre-tax profit and loan loss provision as a measure of predictability, since loan loss provision was the largest accrual on the bank [18]. Thus, variable of EBTLLP_{t + 1} is used which is the amount of profit and loan loss provision one period ahead.

Managerial ability is measured using DEA (Data Envelopment Analysis). DEA is a method used to evaluate the efficiency of a responsible decision-making unit by using a number of inputs to obtain a targeted output. DEA is used to determine the firm's optimal weight on its inputs and outputs. The optimal weight of the company will describe the efficiency of the company. To measure managerial ability, this study used two-stage DEA. DEA approach used is Variable Returns to Scales (VRS). To calculate DEA, DEAP application is used. To measure efficiency with the DEA approach, the model is as follows:

$$Max\theta = \frac{u1Deposits+u2Loans+u3Investment+u4IntInco}{v1PPE+v2Int+v3Labor+v4IntExp+v5RentExp}$$

Where:

θ	= Firm efficiency
Deposits	= Total deposit
Loans	= Loan or credit
Investment	= Investment
IntInco	= Interest income
PPE	= Net properties, plant. & equipment
Int	= Intangible assets
Labor	= Labor costs
IntExp	= Interest charges
RentExp	= Rental expenses

The results of this efficiency captures both firm efficiency and management efficiency. To separate the firm's effect from managerial ability. Following Garcia-Meca & Garcia-Sanchez (2017), we estimate following regression equation:

$$DEAScore = \beta_0 + \beta_1 Size + \beta_2 Market_Share + \beta_3 Cash_Flow + \beta_4 Age + Year + \varepsilon$$

Where:

DEAScore	=	Company efficiency
Size	=	Company size (natural logarithm of total assets)
Market_Share	=	Market share of each bank (total assets divided with total assets from all banking companies)
Cash_Flow	=	Free Cash Flow, 1 if company has positive free cash flow and 0 if otherwise
Age	=	Number of years listed on the stock exchange
ε	=	Residual value

The residual value of the above regression reflects the efficiency level of the management and is used to measure managerial ability (MA).

Table 1: Sample Selection

Criteria	Samples
Listed banks on 31 December 2016	45
Banks listed after year 2010	(15)
Sample listed banks	30
Number of observations 2010-2016	210 rm years

4. Results and Discussion

Table 2 shows descriptive statistics of the variables. Based on table 1. the value of EBT, EBT1, and EBTLLP1 on average have a positive value. This indicates that the most of the sample companies have a positive profitability. Variable MA (managerial ability) has mean -0.0354. In average, thus, managerial ability in our samples are quite low. A lack of managerial ability may indicate that the company's managers have not been able to efficiently manage the company's resources or they do not have sufficient expertise. We use random effect (RE) approach and Generalized Least Square (GLS) technique to run our regressions. Random effect (RE) assumes that error has inter-time and cross-section relationships. Table 3 and Table 4 present the regression results.

Based on the results of the regression in Table 2, coefficient of MA*EBT is negative and significant at 1%. It means that managerial ability has negative influence on earnings persistence (and financial reporting quality). Higher managerial ability result in lower earnings persistence. Thus, H1 is not supported. This result is inconsistent with Garcia-Meca and Garcia-Sanchez [2] which find that managerial ability has positive and significant effect on earnings persistence. However, our result is consistent with Francis[19] and [20]. According to Francis[19] the higher the managerial ability, the manager will tend to take risks and choose challenging projects for the company. Therefore, although they have high managerial ability, it is uncertain that they can reduce uncertainty about earnings persistence as they tend to be risk seeker. Hassanzadeh [20] find that managerial ability has a significant negative effect on earnings persistence. They argue

that the manager with high managerial ability tend to report losses on financial reports due to the opportunistic nature of managers to reduce company taxes. Manager's opportunistic behavior is closely related to earnings management. Adiati [21] suggests that companies that do earnings management have lower earnings persistence than other companies.

SIZE has a significant negative effect on earnings persistence, which means the larger the company the lower the earnings persistence (financial reporting quality). This result is inconsistent with Setyawati[22] which suggest that the larger company has higher financial reporting quality. DEPOSITS has a positive significant influence on earnings persistence. Thus, higher third party funds has a significant positive effect on financial reporting quality. This result is consistent with our expectation. The other control variable (LOANGROWTH) has insignificant effect on earnings persistence.

Regression result on predictability also show managerial ability has negative association with predictability, consistent with earnings persistence result. Again, the result indicates that higher managerial ability result in lower financial reporting quality. Due to mean managerial ability shows negative amount, which means that in average managerial ability in our samples is quite low, it is possible that the negative association is drive by low managerial ability firms. To examine this possibility, we divide our samples into sub sample of low managerial ability and high managerial ability (based on median of managerial ability). The results are presented in Table 5 for earnings persistence and Table 6 for earnings predictability.

From both tables we can see that in low managerial sub sample, we observe consistent results with the main results, which are negative effect of managerial ability on financial reporting quality. Whereas for high managerial ability sub samples, the results show insignificant effect of managerial ability on financial reporting quality.

Table 2: Descriptive Statistics

Variable	Mean	Std. Dev	Min.	Max.
EBT1	0.0190	0.0270	-0.1204	0.0801
EBTLLP	0.0289	0.0255	-0.1417	0.1542
NIT	0.0076	0.0939	-0.0841	1.3510
EBT	3.30	6.88	-8.60	34.00
MA	-0.0354	0.0702	-0.2721	0.0868
SIZE	31.2891	1.6512	28.0767	34.5768
DEPOSIT	96	151	1	740
LOANGROWTH	1.1803	0.6425	0.0010	9.0907
DANI	0.2285	0.4209	0	1
NITT1	0.0059	0.1000 0	-0.4969	1.3510

Table 3: Regression Result of Model 1 – Earnings Persistence

Variable	Coef.	Std. Err.	t-stat	Prob.
EBT	0.000	0.000	6.92	0.000***
MA	0.016	0.006	2.56	0.005***
MA*EBT	0.000	0.000	-3.14	0.001***
SIZE	-0.001	0.001	-1.33	0.092*
SIZE*EBT	0.000	0.000	-6.71	0.000***
DEPOSITS	0.000	0.000	-0.14	0.443
DEPOSITS*EBT	0.000	0.000	3.72	0.000***
LOAN GROWTH	0.003	0.001	6.50	0.000***
LOAN GROWTH*EBT	0.000	0.000	0.22	0.421
_cons	3.970	0.396	10.02	0.000***

***Significant at 1%

**Significant at 5%

*Significant at 10%

Table 4: Regression Result of Model 2 – Earnings Predictability

Variable	Coef.	Std. Err.	t-stat	Prob.
EBT	0.000	0.000	5.73	0.000****
MA	0.015	0.008	1.99	0.024**
MA*EBT	0.000	0.000	-4.08	0.000***
SIZE	-0.001	0.001	1.31	0.095*
SIZE*EBT	0.000	0.000	-5.57	0.000***
DEPOSITS	0.000	0.000	-0.46	0.324
DEPOSITS*EBT	0.000	0.000	3.31	0.001***
LOANGROWTH	0.015	0.001	26.04	0.000***
LOAN GROWTH*EBT	0.000	0.000	-0.83	0.204
_cons	-0.202	0.029	-0.70	0.482*

***Significant at 1%

**Significant at 5%

*Significant at 10%

Table 5: Regression Result of Sub Sample – Earnings Persistence
Panel A: Low Managerial Ability

Variable	Coef.	Std. Err.	t-stat	Prob.
EBT	0.000	0.000	5.06	0.000***
MA	0.017	0.013	1.37	0.085*
MA*EBT	0.000	0.000	-1.72	0.043**
SIZE	-0.002	0.001	-1.23	0.110
SIZE*EBT	0.000	0.000	-4.87	0.000***
DEPOSITS	0.000	0.000	0.41	0.341
DEPOSITS*EBT	0.000	0.000	1.21	0.114
LOANGROWTH	-0.008	0.008	0.97	0.166
LOAN GROWTH*EBT	0.000	0.000	0.03	0.486
_cons	0.689	0.039	1.78	0.076*

Panel B: High Managerial Ability

Variable	Coef.	Std. Err.	t-stat	Prob.
EBT	0.000	0.000	2.31	0.011**
MA	0.010	0.069	0.14	0.444
MA*EBT	-0.000	0.000	-0.49	0.311
SIZE	0.001	0.002	0.20	0.422
SIZE*EBT	-0.000	0.000	-2.21	0.014**
DEPOSITS	-0.000	0.000	-0.87	0.193
DEPOSITS*EBT	0.000	0.000	1.30	0.097*
LOANGROWTH	0.003	0.001	4.52	0.000***
LOAN GROWTH*EBT	0.000	0.000	0.08	0.470
_cons	0.004	0.071	0.06	0.955

***Significant at 1%

**Significant at 5%

*Significant at 10%

Table 6: Regression Result Sub Sample – Earnings Predictability

Panel A: Low Managerial Ability				
Variable	Coef.	Std. Err.	t-stat	Prob.
EBT	0.000	0.000	4.20	0.000***
MA	0.003	0.017	0.17	0.435
MA*EBT	-0.000	0.000	-1.99	0.024**
SIZE	-0.000	0.002	-0.23	0.411
SIZE*EBT	-0.000	0.000	-4.06	0.000***
DEPOSITS	0.000	0.000	0.91	0.181
DEPOSITS*EBT	0.000	0.000	0.90	0.184
LOANGROWTH	0.016	0.004	4.53	0.000***
LOAN GROWTH*EBT	-0.000	0.000	-0.85	0.198
_cons	0.030	0.045	0.67	0.500

Panel B: High Managerial Ability				
Variable	Coef.	Std. Err.	t-stat	Prob.
EBT	0.000	0.000	1.82	0.035**
MA	0.103	0.063	1.63	0.052*
MA*EBT	-0.000	0.000	-0.96	0.170
SIZE	0.001	0.003	0.43	0.335
SIZE*EBT	-0.000	0.000	-1.70	0.045**
DEPOSITS	-0.000	0.000	-0.96	0.170
DEPOSITS*EBT	0.000	0.000	0.35	0.362
LOANGROWTH	0.016	0.001	17.00	0.000***
LOAN GROWTH*EBT	0.000	0.000	0.08	0.466
_cons	-0.021	0.075	-0.28	0.777

***Significant at 1%

**Significant at 5%

*Significant at 10%

5. Conclusion

This study aims to find empirical evidence about the influence of managerial ability on financial reporting quality of listed banks in Indonesia. Based on our regression results, we find that managerial ability has a negative and significant effect on the financial reporting quality (measured by earnings persistence and earnings predictability). Higher managerial ability does not able to increase the financial reporting quality. These results are inconsistent with Garcia-Meca & Garcia-Sanchez[2] which find that managerial ability has a positive effect on the bank financial reporting quality. However, these results consistent with Francis[19] and Hassanzadeh [20]which find that managerial ability has a negative effect on financial reporting quality. This may be due to when the manager has higher ability, he/she tends to be opportunistic and take actions (such as opportunistic earnings management) and thus earnings become less persistent as well as less predictable (low financial reporting quality).

There are some limitations of our study. As we are only examining banking industry, our samples tend to limited. The results of this study also cannot be generalized to other industries. We also only use two measurements of financial reporting quality (earnings persistence and predictability). Further studies may extend the samples to non-listed banks and may use other proxies to measure financial reporting quality.

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