

Does Reputation Work? Evidence from Investors' Perception on Earnings

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Abstract: This study investigates the effect of CEO reputation, as proxied by high-profile awards to CEOs, on investors' predictability of earnings. Existing literature has documented that the actions of business stakeholders are affected by reputation concerns. We provide two competing theories of the CEO reputation effect on financial reporting quality: the alignment effect and the entrenchment effect. Using the approach of earnings-return association, we find evidence that, after superstar CEOs receive the high profile award, current stock returns incorporate future earnings information much more weakly than prior to the award. The results suggest that, consistent with the entrenchment effect, the reputation induces CEOs to produce lower quality financial reporting in order to avoid any repercussions from missing capital market expectations.

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1. Introduction

This study investigates whether CEO reputation affects the ability of investors' earnings prediction. Even though recent studies (e.g., Bamber et al. 2010, Ge et al. 2010) are successful to identify time-invariant managerial effects on financial reporting, we know little about the effect of CEOs reputation, a specific and time-varying managerial attribute, on investors' predictability of earnings. We focus on the investors' perspective of financial reporting (i.e., earnings) because CEOs reputation can affect the quality of financial reporting and disclosure. We examine this issue by comparing changes in the association between current-period stock returns and future earnings before and after each CEO wins the high-profile award.

CEO reputation encompasses perceptions about CEO ability and values (Francis et al. 2008), and can affect the CEO's incentives to disclose information about their firms' economic prospects in two ways: the alignment effect and the entrenchment effect. The alignment effect is based on the argument that an employee's reputation serves to encourage worker discipline because it provides potential employers information about the quality of the employee (MacLeod and Malcomson 1988). Thus, superstar CEOs, who have earned awards and achieved media recognition as talented managers, have greater incentives to align their actions with stakeholders' interest in order to preserve their reputations. If stakeholders value high quality financial information, superstar CEOs have strong incentives to promote transparency by actively disclosing information about their firms' economic prospects (Trueman 1986, Easley and O'Hara 2004).

An alternative view is the entrenchment effect. The entrenchment effect is based on the argument that highly reputed CEOs become distracted by their fame and act in opportunistic ways to preserve their personal reputations. One external effect of having a superstar CEO is that market and analyst expectations for future firm performance likely increase (Malmendier and Tate 2009). Therefore, superstar CEOs are under constant pressure to meet unrealistically high performance expectations. If superstar CEOs allow their perks of success to distract them from effectively running the company, they may find it difficult to meet the hyped market's expectations and are, in turn, driven to take opportunistic actions that ultimately reduce the quality of financial reporting (Francis et al. 2008).

In sum, it is *ex ante* unclear whether superstar CEOs will improve or garble the quality of financial reporting. Accordingly, we address this issue empirically.

2. Data and Research Design

In this study, we use high-profile awards as a proxy for reputation. Specifically, we exploit shifts in CEO status due to CEO awards conferred by major national media organizations. Hand-collected data on high-profile awards come from various publications: *Business Week*, *Financial World*, *Chief Executive*, *Forbes*, *Fortune*, *Monrningstar.com*, *Time*, and *Time/CNN*. We identify 193 CEOs who won an award from 1992 to 2007. In order to examine the effect of CEO reputation on earnings predictability, we compare within-firm changes in investors' ability to predict future earnings before and after each CEO wins the high-profile award. To measure earnings predictability, we use the modified version of Collins

et al.'s (1994) return-future earnings regression model. Specifically, we estimate the following model:

$$R_t = \beta_0 + \beta_1 X_{t-1} + \beta_2 X_t + \beta_3 X_{t+1} + \beta_4 R_{t+1} + \beta_5 BM_t + \beta_6 V_t + \beta_7 AG_t + \beta_8 POST + \beta_9 POST * X_{t-1} + \beta_{10} POST * X_t + \beta_{11} POST * X_{t+1} + \beta_{12} POST * R_{t+1} + \beta_{13} POST * BM_t + \beta_{14} POST * V_t + \beta_{15} POST * AG_t + u_t \quad (1)$$

where X_{t-1} is earnings change per share in period t-1 deflated by the stock price four months after the end of the fiscal year t-1; X_t is earnings change per share in period t deflated by the stock price four months after the end of the fiscal year t-1; X_{t+1} is earnings change per share in period t+1 deflated by the stock price four months after the end of the fiscal year t-1; R_t is stock return for period t; R_{t+1} is stock return for period t+1; BM_t is book to market ratio in period t; V_t is the standard deviation of the contemporaneous 12 month abnormal returns; AG_t is the total assets growth for period t; $POST$ is 1 if fiscal year belongs to post-award winning period and 0 otherwise.

Following prior studies (Malmendier and Tate 2009, Kim 2012), our study seeks to test whether CEOs' reputation concern leads to a change in financial reporting and eventually investors' predictability of future earnings. The alignment effect predicts that superstar CEOs, after receiving the high-profile award, provide higher quality financial

reporting and, thereby, enhance earnings predictability than prior to the award. In this regard, we expect the future earnings response coefficient (FERC, β_{11}) to be positive and significant in the regression model (1). In contrast, the entrenchment effect predicts that superstar CEOs, after receiving the high-profile award, provide lower quality of financial reporting and, thereby, deteriorate earnings predictability than prior to the award. Therefore, we expect β_{11} to be negative and significant.

3. Results

Table 1 reports within-firm changes of investors' predictability of earnings. First, we run the equation (1) with one year pre- and post- period in order to examine the difference of investors' predictability of future earnings. Then, we extend the sample period from one year pre- and post- period to three year pre- and post- period. In all the three columns, the coefficient on $POST * X_{t+1}$ (β_{11}) is significantly negative, suggesting that current stock returns incorporate future earnings information much more weakly after superstar CEOs receive the high profile award than prior to the award. It is consistent with the entrenchment effect that superstar CEOs produce lower quality financial reporting to avoid any repercussions from missing capital market expectations.

Table 1. FERC (Superstar CEOs Sample)

Period	(1) Pre/Post 1 year	(2) Pre/Post 2 year	(3) Pre/Post 3 year
	Coefficients (p-value)	Coefficients (p-value)	Coefficients (p-value)
Intercept	-0.141 (0.066)	-0.131 (0.023)	-0.118 (0.023)
X_{t-1}	-0.412 (0.495)	-0.039 (0.912)	-0.054 (0.863)
X_t	0.670 (0.469)	-0.356 (0.463)	0.466 (0.203)
X_{t+1}	3.393 (0.000)	2.511 (0.000)	1.986 (0.000)
R_{t+1}	0.014 (0.845)	0.024 (0.578)	0.004 (0.912)
BM_t	-0.674 (0.000)	-0.518 (0.000)	-0.595 (0.000)
V_t	4.151 (0.000)	4.705 (0.000)	4.473 (0.000)
AG_t	0.061 (0.020)	0.039 (0.076)	0.047 (0.028)
POST	0.277 (0.013)	0.154 (0.061)	0.159 (0.029)
$POST * X_{t-1}$	-0.945 (0.239)	-0.882 (0.083)	-0.912 (0.046)
$POST * X_t$	0.962 (0.372)	1.936 (0.002)	0.800 (0.106)
$POST * X_{t+1}$	-2.665 (0.004)	-1.987 (0.002)	-1.689 (0.001)
$POST * R_{t+1}$	0.231 (0.013)	0.171 (0.007)	0.142 (0.014)
$POST * BM_t$	0.258 (0.177)	0.236 (0.067)	0.306 (0.005)
$POST * V_t$	-5.045 (0.000)	-5.155 (0.000)	-4.630 (0.000)
$POST * AG_t$	0.199 (0.000)	0.206 (0.000)	0.167 (0.000)
N	386	740	1,074
Adj-R ²	0.43	0.39	0.33

4. Sensitivity Test

A potential concern with the results in the previous section is that endogenous firm-level characteristics may drive the results. In this regard, we employ a sensitivity test using a control sample of non-superstar CEOs who are predicted to win awards. These managers are selected based on the similarity of their financial performance and condition to those of firms with superstar CEOs prior to the award winning. We refer to this matched control sample as “predicted winners.” We construct predicted winners in two steps. First, we run an award prediction model with superstar CEOs and COMPUSTAT sample to estimate the coefficients on explanatory variables.

$$\text{WIN} = \alpha_0 + \alpha_1 \text{SIZE} + \alpha_2 \text{BM} + \alpha_3 \text{ROA} + \alpha_4 \text{RET} + \alpha_5 \text{V} + \text{Industry Indicator} + \text{Year Indicator} + \varepsilon \quad (2)$$

where WIN is an indicator variable to be 1 if the firm wins the award; SIZE is the log of firm’s total assets; BM is book-to-market ratio; ROA is the return on assets, computed as income before extraordinary items scaled by lagged total assets; RET is the contemporaneous 12 month return less value-weighted market return; V is the standard deviation of the contemporaneous 12 month abnormal returns.

Table 2 presents the results of the logit regression (2). Managers of larger firms with higher accounting performance and market returns are significantly more likely to win awards.

Table 2. Determinants of CEO awards

Variable	Coefficients	χ^2 -stat
SIZE	0.788	288.843
BM	-0.363	48.657
ROA	3.254	25.381
RET	1.672	39.571
V	-0.849	0.253
N	12,792	
Pseudo R ²	0.289	

Then, we use the propensity scores to construct the predicted winners sample for the award winners. In each award year, we choose, with replacement, the non-winning managers with propensity scores closest to those of each actual award winners. Table 3 compares the characteristics between firms managed by superstar CEOs and those managed by predicted winners. There are no differences in all five variables, suggesting that the predicted winners sample shares similar economic conditions and firm performance to the superstar CEOs sample.

Table 3. Superstar CEOs versus Predicted Winners

Variable	Superstar CEOs	Predicted Winners	Difference	t-stat
SIZE	9.046	9.560	-0.514	-.013
BM	0.375	0.372	0.003	0.14
ROA	0.060	0.069	-0.009	-1.22
RET	0.027	0.041	-0.014	-0.26
V	0.086	0.087	-0.001	0.15

To examine the difference of investors’ predictability of earnings between pre- and post-award period, we re-run the equation (1) with only firms with predicted winners. The results are reported in Table 4 and indicate that there is no difference of investors’ predictability of earnings between two periods. These results suggest that our main inference about the CEO reputation effect on earnings predictability in the previous section is not driven by endogenous firm-level characteristics used to identify superstar CEOs.

Table 4. FERC (Predicted Winners Sample)

Period	(1) Pre/Post 1 year	(2) Pre/Post 2 year	(3) Pre/Post 3 year
	Coefficients (p-value)	Coefficients (p-value)	Coefficients (p-value)
Intercept	0.180 (0.159)	-0.101 (0.266)	-0.016 (0.8299)
X_{t-1}	-0.563 (0.366)	-0.749 (0.1096)	-0.748 (0.0359)
X_t	2.225 (0.050)	-0.078 (0.8892)	0.073 (0.8802)
X_{t+1}	-0.095 (0.938)	1.273 (0.0661)	0.803 (0.1461)
R_{t+1}	-0.120 (0.091)	-0.085 (0.1291)	-0.008 (0.8337)
BM_t	-0.341 (0.049)	-0.272 (0.0145)	-0.263 (0.0022)
V_t	3.84 (0.000)	2.969 (0.0001)	1.910 (0.0016)
AG_t	0.17 (0.099)	0.427 (0.0001)	0.412 (0.0001)
POST	0.058 (0.736)	0.081 (0.4977)	-0.097 (0.3131)
POST* X_{t-1}	-1.131 (0.370)	0.960 (0.1861)	0.540 (0.3603)
POST* X_t	-0.363 (0.810)	1.557 (0.0592)	2.436 (0.0005)
POST*X_{t+1}	2.004 (0.201)	-0.683 (0.4038)	-0.371 (0.5608)
POST* R_{t+1}	0.039 (0.733)	0.047 (0.5470)	-0.025 (0.6888)
POST* BM_t	-0.039 (0.871)	-0.149 (0.3109)	-0.048 (0.6388)
POST* V_t	-1.006 (0.439)	-1.932 (0.0344)	-0.366 (0.6259)
POST* AG_t	-0.182 (0.093)	-0.427 (0.0001)	-0.412 (0.0001)
N	386	740	1,074
Adj-R ²	0.09	0.05	0.03

4. Conclusion

In this study, we provide two competing theories of the CEO reputation effect on financial reporting quality: the alignment effect and the entrenchment effect. Based on the argument that highly reputed CEOs have incentives to align their actions with stakeholders' interests (Fama 1980), the alignment effect predicts that superstar CEOs, after receiving the high-profile award, enhance earnings predictability than prior to the award. In contrast, the entrenchment effect is based on the argument that highly reputed CEOs become distracted by their fame and act in opportunistic ways to preserve their personal reputations (Malmendier and Tate 2009). This leads to the prediction that superstar CEOs, after receiving the high-profile award, deteriorate earnings predictability than prior to the award.

In order to examine the effects of CEOs reputation on the investors' ability to predict future earnings, we compare within-firm changes in investors' ability to predict future earnings. The results suggest that the reputation of managements plays an important role in financial reporting practice. Particularly, consistent with the entrenchment effect, firms managed by superstar CEOs deteriorate the ability of investors to predict future earnings. This result suggests that the reputation induces CEOs to

produce lower quality financial reporting in order to avoid any negative effects from missing hyped capital market expectations.

While this study provides evidence that managerial reputation plays a role in corporate financial reporting, it has limitations. Since this study focuses on the reputation increase around a particular level (i.e., the change in reputation captured by winning an high-profile award), the result may be difficult to generalize to a continuum of reputation that lies outside of this level.

With this caveat in mind, this study contributes to the literature in the following ways. First, this study contributes to literature on financial reporting quality by explicitly considering a managerial human capital dimension (i.e., reputation) in explaining the cross-sectional variation in earnings predictability. Prior studies largely ignore the role of manager-specific attributes on disclosure quality. Two exceptions are recent studies by Bamber et al. (2010) and Ge et al. (2010). While these studies use fixed-effects analyses and successfully identify time-invariant managerial effects on financial reporting, we explicitly link managerial reputation, a specific and time-varying managerial attribute, to the quality of corporate financial reporting.

Second, this study contributes to the literature on the reputation effect of business stakeholders. Prior studies argue that the reputation of business stakeholders (e.g., financial analysts and auditors) serves as an effective mechanism for worker self-discipline (Becker et al. 1998, DeFond and Jiambalvo 1991, Fang and Yasuda, 2009, Francis and Krishnan 1999, Nikoumaram et al. 2012; Stickel 1992). While these studies illuminate a bright side of reputation effect, our results show that superstar CEOs may act in opportunistic ways that are detrimental to firm value in order to protect their personal reputation.

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