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Beware of Earnings Reports From Companies With New CEOs

Unproven leaders tend to overstate results as they establish their reputations, a study suggests

By **TODDI GUTNER**

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Beware of earnings reports from companies with new chief executive officers.

So suggests new research from Ashiq Ali, an accounting professor at the University of Texas at Dallas, and Weining Zhang, assistant professor of accounting at Cheung Kong Graduate School of Business in China, that was published in this month's Journal of Accounting and Economics.

In their study, the professors found that chief executives have greater incentives to overstate earnings in their first three years on the job to favorably influence the market's perception of their ability.

The Wall Street Journal recently spoke with Mr. Ali about the paper. Here are edited excerpts.

WSJ: What was the reason for this study?

DR. ALI: There have been several studies about the various incentives CEOs have to understate or overstate earnings in their first and last years in the position—but no research had been done on CEO earnings management throughout their tenure and their reasons for doing it.

WSJ: What did you find?

DR. ALI: We found that CEOs overstate earnings more in the first three years than in later years, and that this

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overstatement increases reported [return on assets] by about 25% on average.

It isn't likely they do it every quarter for the first 12 quarters because that wouldn't be sustainable.

CEOs use different earnings-management strategies such as discretionary accruals, abnormal discretionary expenses like research-and-development expense, and special items. As you would expect, the earnings overstatement is less at companies that have stronger monitoring through analyst coverage, and board and audit-committee independence.

WSJ: How do you explain your findings?

DR. ALI: In the early years, a CEO's ability is unknown, and he or she is concerned that if poor performance is reported, then the market will assess them negatively and they will be terminated. That would come at a huge cost because their career would be affected.

So, while new CEOs work very hard to perform well in the first three years, they also manage their earnings upward until they have established a reputation of high ability.

Once their career is no longer on the line, they lose the incentive to overstate earnings.

For the last year of service, other studies have shown that CEOs have an incentive to overstate their earnings, in part, because their pension plan is positively tied to their last year of pay.

WSJ: What is the relevance of this study?

DR. ALI: Investors and directors should be more skeptical about reported earnings in the early years of a CEO's service. They should be a bit more concerned and use tools they have to raise questions. If R&D is cut, for example, the board of directors should try to understand why it was cut.

Ms. Gutner is a writer in Chappaqua, N.Y. She can be reached at reports@wsj.com.

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