International Business & Economics Studies
ISSN 2640-9852 (Print) ISSN 2640-9860 (Online)
Vol. 4, No. 4, 2022
www.scholink.org/ojs/index.php/ibes

Original Paper

Effects of Quality of Financial Statements and CEO Turnover

Yu-Ting Huang[1], Peng-Tung Chen[1*], Hung-Tu Huang[2] & Hsiu-Chen Chou[2]

[1] Department of Business Administration, MingDao University, Changhua, Taiwan

[2] EMBA Program, MingDao University, Changhua, Taiwan

[*] Peng-Tung Chen, Department of Business Administration, MingDao University, Changhua, Taiwan

Received: August 25, 2022 Accepted: September 28, 2022 Online Published: October 3, 2022

doi:10.22158/ibes.v4n4p8 URL: http://dx.doi.org/10.22158/ibes.v4n4p8

Abstract

The purpose of this study is to explore the effect of CEO turnover and CFO turnover on earnings management. In addition, Taiwan's authorities will require listed companies to complete the establishment of audit committee replacing supervisors in 2022. Corporate governance is not an overnight phenomenon. It has been existing from a long time. It is only that the beginning of 21st century when colossal enterprises started to fall, government across globe started giving it due credit. The present paper is an attempt to trace the history of corporate governance. It starts with discussing various theories which led to the development of such an important concept and then dwells on various models in which economies employ corporate governance in their structure and finally the evolution of corporate governance across globe. The paper sheds light on important committees and reforms which have been the genesis of corporate governance across globe. It undertakes an extensive literature review on different aspects of corporate governance. Corporate governance is a concept which still debatable among experts in describing it. The purpose of this study is to explore how the implementation and principal problems of good corporate governance in the management of current limited liability company.

Keywords

CEO turnover, corporate governance, quality of financial statements

1. Introduction

Corporate governance, operator compensation and performance are public issues that have attracted international attention in recent years. In terms of the operator compensation system, it is often regarded as a recipe for aligning the interests of managers and shareholders and can effectively restrain managers and shareholders. Conflicts of interest and agency issues between them and help to improve the company's operating performance and shareholder value. However, since the 1990s in the United

States, the rapid economic growth in the United States has led to the activation of the capital market, and the common use of stock options in the corporate world as a compensation tool to link compensation and performance. The substantial increase in executive compensation can be attributed to the undue influence and control of the board by the CEO, as well as the failure to effectively link the compensation structure to performance. The rising turnover rate of managers is a global trend. The American magazine “Business and Strategy” publishes a report on the turnover rate of managers every year. In 2005, 15.3% of the world’s top managers left, which is the highest rate in recent years, and it has been more than ten years. Compared to before, it has grown by 70%. In the past decade or so, the research on CEO turnover at home and abroad has almost focused on corporate performance (Murphy & Zimmerman, 1993; Denis & Denis, 1995).

Regarding the relationship between CEO turnover and company performance, the research results of relevant scholars at home and abroad have no consistent conclusions. One of scholars proposes that when the company’s operating performance declines, the company will replace senior managers to improve its performance (Weisbach, 1988; Denis & Denis, 1995; Huson et al., 2001; Shen & Cannella, Jr., 2002). Another of scholars believes that when a company replaces top managers, it often leads to a decline in the company’s operating performance (Beatty & Zajac, 1987). This study will explore the relationship between CEO turnover and earnings management, using earnings management as a measure of the quality of financial statements, and to help investors and companies understand the effectiveness of corporate governance implementation.

2. Literature Review

The purpose of financial reporting is to provide effective financial information to external users in a timely and reliable manner. As managers can use their business knowledge to improve the effectiveness of financial reporting, managers could adjust financial reporting. Managers have discretion over accounting choices, so when managers have an incentive to misrepresent users of financial statements, managers’ behavior in earnings management may occur.

When the company’s pre-manipulation earnings are at a loss or lower than the previous performance, the company has the behavior of manipulating earnings to raise the book earnings to achieve the performance threshold, and when the company’s managers’ remuneration is more closely linked to accounting performance, managers will perform a relatively high degree of earnings management. Watts and Zimmerman (1978) proposed three motivations for managers to carry out earnings management: the bonus plan hypothesis, the debt-equity hypothesis, and the size hypothesis. Furthermore, Healy, and Wahlen (1999) have organized the literature on earnings management from the perspective of standard legislators, and defined earnings management as: managers use discretionary powers that can be adjusted in financial reporting and structuring transactions to modify financial reports to Misrepresenting certain stakeholders related to a company’s economic performance, or to influence contractual outcomes that rely on accounting figures. In general, managers can use the following four methods to adjust financial reports: (1) accounting estimates, such as the useful life and residual value of long-term assets; (2) the choice of accounting methods, such as depreciation methods can choose straight-line method or Accelerated depreciation method; (3) working capital management, such as the point in time when inventory is shipped or purchased; (4) the recording or deferral of expenses, such as research and development expenditures.

Regarding the relationship between CEO turnover and company performance, there is no consistent conclusion in the past research results at home and abroad. One of scholars proposes that when the company's operating performance declines, the company will replace senior managers to improve its performance (Huson et al., 2004; Shen & Cannella, 2001). However, another of scholars believes that when a company replaces senior managers, it often leads to a decline in company performance (Beatty & Zajac, 1987). Many empirical studies point out that manager turnover and performance are negatively related (Beatty & Zajac, 1987; Weisbach, 1988; Suchard, 2001).

Among the reasons for CEO turnover, financial performance is the most obvious factor that will affect their change. Therefore, in order to avoid reporting the decline or loss of earnings, the company's senior managers will lead to changes in their fortunes, so it is a common phenomenon in practice to dominate earnings management (Burgstahler & Dichev, 1997). Common empirical studies have also found that top management will implement earnings management methods for the financial forecast of the next year (Kasznik, 1999; Plummer & Mest, 2001).

De Angelo (1988) found that managers may manipulate earnings through adjudicative accruals to beautify their operating performance in order to protect the right to operate; Scott and Pitman (2001) also confirmed that management does through manipulation The way of earnings affects present and future rewards; Myers and Skinner (2000) found that since 1987, 399 large companies reported a steady increase in reported earnings for 17 consecutive quarters, which may be caused by the phenomenon of earnings management. According to the above literature, different reasons for CEO turnover will have different effects on company performance, and when the successor is under performance pressure, senior managers are likely to have earnings management behaviors, so different reasons for CEO turnover will also It will affect the earnings management of senior managers. However, from a strategic point of view, when the main reason for the change of senior managers is strategy, because it is not mainly for finance, and the strategic direction is mainly long-term and stable, it belongs to rational long-term planning, so the phenomenon of earnings management is less. From the perspective of other reasons for changes (such as CEO turnover, retirement at age), since it is a normal change, the phenomenon of earnings management should also be small. Different reasons for the change of senior managers will also produce different degrees of earnings management. Therefore, hypothesis 1 is formed in this study.

H1: CEO turnover has significant differences in earnings management.

This study examines how CEO turnover in Taiwan-listed companies affects earnings quality to determine its nature and gain insight into its causes and consequences. The second chapter is the literature review, the third chapter is the research design, explaining the data source and the design of the empirical model, the fourth chapter is the descriptive statistics and empirical analysis results, and finally the fifth chapter is the conclusion and discussion.

3. Research Method

3.1 Sample Selection

In the empirical analysis of this research, the research of this research is developed through references, relevant research variables and literatures are collected, an empirical model is established, and appropriate data analysis methods are adopted. This study takes the listing (cabinet) of the Taiwan Stock Exchange from 2018 to 2020 as the research object, and explores the impact of the correlation between CEO turnover and earnings management. The data source is the financial database of Taiwan Economic Journal (TEJ). Table 1 is the sample selection and data sources for this study, and domestic listed OTC companies are used as the research sample companies. Table 1 presents the annual distribution of the research samples, showing that the proportion of companies with CEO turnover accounted for about 1,592 (33.75%), and the proportion of non-CEO turnover accounted for about 3,125(66.25%).

Table 1. Samples

Yearly Distribution

Yearly / Type	2018	2019	2020	Total
CEO turnover	525	589	478	1,592(33.75%)
Non-CEO turnover	1,305	878	942	3,125(66.25%)
Total	1,830	1,467	1,420	4,717
%	38.80%	31.10%	30.10%	100.00%

3.2 Research Design and Empirical Proxies

3.2.1 The Empirical Models

$$\mathrm{TM}_{i.t} = \alpha_0 + \alpha_1 CEOT_{i,t} + \alpha_2 ROA_{i,t} + \alpha_3 GROUTH_{i,t} + \alpha_4 CATA_{i,t} + \alpha_5 DC_{i,t} + \alpha_6 DE_{i,t}$$

Where:

TM	=	Earnings Management. The quality of financial statements are measured by earnings management.
CEOT	=	Dummy variable, 1 if the manager has changed in 3 years, 0 otherwise.
ROA	=	Return on total assets.
GROWTH	=	Revenue growth rate.

CATA	=	Current ratio.
DC	=	Dummy variable, 1 if the chairman is concurrently the general manager, 0 otherwise.
DE	=	Debt ratio.

3.2.2 Related Variables and Operational Definitions

Senior executives generally refer to the CEO of a company or enterprise, that is, the highest decision-maker within the enterprise. The senior executive in this study is defined as the general manager. CEO turnover (*CEOT*) refers to the change of the general manager or the change of the information. This important information is used as the event date of the change of the general manager. For the company's operating performance, the revenue growth rate (*GROWTH*), return on total assets (*ROA*), current ratio (*CATA*), debt ratio (*DE*), chairman and general manager (*DC*) are used as the controls for this study. variable. Earnings management is measured using Jones Model, with discretionary accruals as proxy variables for earnings management. In earnings management methods, accruals are of a summary nature and are less noticeable to report users. Therefore, it is possible for companies to use this method. The detection ability of the Modified Jones Model is better. In addition, Rangan (1998) believes that the use of discretionary short-term accruals (Discretionary Current Accruals) to detect the company's earnings management behavior has a better effect.

4. Empirical Results

4.1 Descriptive Statistic

Table 2 is the descriptive statistics. In order to understand the basic differences between all the samples and managers with changes and managers without changes, first observe the earnings management (*TM*), CEO turnover (*CEOT*), revenue growth rate (*GROWTH*), total assets Return ratio (*ROA*), current ratio (*CATA*), debt ratio (*DE*), chairman and general manager (*DC*), it can be found that companies with CEO turnover has lower earnings management, higher revenue growth rate, A higher return on total assets, a lower debt ratio, and a lower chairman serving as general manager indicate that if the company has CEO turnover, it can effectively restrain earnings management.

Table 2. Descriptive Statistics

	Total (n=4,717)			CEO turnover (n=1,592)			Non-CEO turnover (n=3,125)		
Variables [a]	Mean	Median	Std. Dev	Mean	Median	Std. Dev	Mean	Median	Std. Dev
TM	-0.0310	-0.0378	0.1211	-0.0287	-0.0317	0.1578	-0.0301	-0.0327	0.0817
CEOT	0.3286	0.0021	0.4153	1.000	1.0000	0.0000	0.7437	1.0000	0.4380
ROA	0.0795	0.0852	0.1189	0.0157	0.0717	0.1219	0.0000	0.0000	0.0000
GROWTH	0.1300	0.0151	2.3121	0.2285	0.0086	3.8990	0.08875	0.0882	0.0911
CATA	3.1912	1.9420	9.5877	3.3814	1.8951	8.7742	0.0515	-0.0085	0.6965

DC	0.4317	0.4221	0.2012	0.5120	0.4217	0.2070	3.1010	1.9598	9.9242
DE	0.3207	0.0010	0.4687	0.3180	0 .0000	0.4617	0.4241	0.4020	0.2000

NOTE: [a] As defined above for variables.

4.2 Correlation Matrix

This study uses the Pearson Correlation coefficient to test the correlation between the variables and explores the direction and extent of the influence between the variables. Table 3 shows that the rates of earnings management (*TM*) and CEO turnover (*CEOT*) are significantly negative. Correlation (correlation coefficient is -0.0092), which means that companies with CEO turnover have lower earnings management. However, revenue growth rate (*GROWTH*), return on total assets (*ROA*), current ratio (*CATA*), debt ratio (*DE*) showed a positive correlation, but did not appear significant. In addition, the relationship between the chairman and the general manager (*DC*) is negative, but not significant. In this study, the variance inflation factor (VIF) test was used, and the VIF value of each variable in the regression model was not greater than 10, indicating that there was no collinearity problem among the variables.

Table 3. Correlation Matrix (n=4,717)

Variables [a,b]	*TM*	*CEOT*	*ROA*	*GROWTH*	*CATA*	*DC*	*DE*
TM	1.0000						
CEOT	-0.0092	1.0000					
ROA	0.0678	-0.1028	1.0000				
GROWTH	0.0590	0.0509	-0.0197*	1.0000			
CATA	0.0288	0.0127	-0.0698*	0.0353*	1.0000		
DC	0.0511	0.0311	-0.2315	0.0198*	-0.2732	1.0000	
DE	-0.0059	-0.0057*	-0.0410*	-0.0138*	0.0429*	-0.0812*	1.0000

Note. [a] As defined above for variables.

[b] * Indicates a significant level of 10%;

** indicates a significance level of 5%;

*** indicates a significance level of 1%. If there is an expected sign, the p value is a one-tailed test, otherwise the p value is a two-tailed test.

4.3 Results of Regression Analysis-Regression Analysis of Earnings Management (TM) and CEO turnover (CEOT)

Many previous studies (Huson et al., 2004; Furtado & Rozeff, 1987; Davidson III et al., 1990) pointed out that CEO turnover is negatively correlated with operational performance, so this study uses earnings management as a variable for performance measurement, the research results show that when managers encounter the risk of replacement due to poor business performance, they will be easily motivated by earnings management behavior, so their company's earnings may be manipulated by managers and the company's true operating conditions will be distorted. It is the current trend for companies to use performance as an indicator. Once a company's performance is not good, CEO turnover information may affect investors' uncertainty about the company's future prospects. Therefore, this study explores companies whose managers have changes. Whether the impact on earnings management (TM) is different due to the change of managers within 3 years, and further incorporates whether the manager has changed into the regression analysis. The empirical results show that under the change of managers, the estimated coefficient of CEO turnover (*CEOT*) It is -0.2189 (t=-5.15, p<0.05), reaching a negative and significant level, indicating that if there is a manager in the company, it means that the company's performance has a significant impact on the CEO turnover (*CEOT*), which is in line with the hypothesis H1 of this research. The reason is that if the manager decides the company's operating decisions, the manager will engage in earnings management out of self-interest motives. Therefore, the regular changes of the manager will reduce the doubts of the external investment public and improve the reliability of reporting earnings. It helps the company to have better financial statement quality. In addition, in the sample number of managers with no change, although it is positive, it is significant, indicating that the manager can infer that the manager has no change in the company's earnings management, but there is no change. Because it is not significant, because there is not much effect.

Table 4. Regression Analysis of Earnings Management and CEO turnover

		CEO turnover		Non- CEO turnover	
Variables [a]	**Pred. Sign**	**Coef.**	***t-value*** [b]	**Coef.**	***t-value***
CONSTANT		-0.0933	-6.07***	-0.04073	-7.02
CEOT	-	-0.2189	-5.15 **	0.0071	0.34
ROA	?	0.0028	2.17*	-0.0046	-0.02
GROWTH	?	0.0015	2.48**	0.0033	1.74
CATA	?	0.0965	3.55	0.0231	2.31
DC	?	-0.0085	-0.78*	-0.0023	-0.57**
DE	?	0.0132	0.21	-0.0327	-0.14
Adj. R^2		54.78%		68.10%	
Nobs.		1,592		3,125	

Note: [a] As defined above for variables.

[b] * Indicates a significant level of 10%;

** indicates a significance level of 5%;

*** indicates a significance level of 1%. If there is an expected sign, the p value is a one-tailed test, otherwise the p value is a two-tailed test.

5. Conclusions and Recommendations

This study takes the listing (counter) of the Taiwan Stock Exchange from 2018 to 2020 as the research object and explores the impact of the correlation between CEO turnover and earnings management. The data source is the financial database of Taiwan Economic Journal (TEJ). Therefore, this study examines how the CEO turnover of listed companies in Taiwan will affect their earnings quality. The empirical results show that CEO turnover are often seen. However, CEO turnover also affect the organization's operational policy direction and profitability. considerable impact. Therefore, the empirical results of this paper show that if the company has a CEO turnover, it means that the company's performance has a significant impact on the manager replacement. Engaged in the behavior of earnings management, it is easy to have the motivation to manipulate earnings management.

When an enterprise slows down managers, it should not only focus on internal decision-making, but also consider changes in the external environment. Therefore, when selecting managers, it is necessary to select managers who are familiar with the internal operation of the enterprise, familiar with the industrial environment, and able to grasp the operating environment. Only managers who adopt appropriate strategies based on the situation can ensure the growth of the enterprise. However, if an enterprise wants to truly measure the impact of the successor on the enterprise performance after the CEO turnover it should take more years to see the real business performance, to avoid the phenomenon of earnings management that confuses the business performance. In addition, companies should fully disclose the company's information in terms of finance, earnings, assets, etc., and maintain openness and transparency, so as to reflect the effectiveness of operations on the spot, so that the public will not be confused about the information released by the company. This results in information bias and affects investment decisions. This study hopes to inspire more researchers to conduct empirical research on the turnover of senior managers in enterprises through the propositions in this paper, so as to establish a more complete theory.

Acknowledgement

Yu-Ting Huang**: Study conception and design. Drafting of the article.** Peng-Tung Chen**: Data collection, Data analysis and interpretation, Critical revision of the article.** Hung-Tu Huang & Hsiu-Chen Chou**: Data collection, Drafting of the article.**

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