Abstract: In this paper, we use an international setting to examine an unresolved issue in the literature on the relation between managerial ability and earnings quality. We also examine whether the strength of a country’s investor protection system impacts this relation. Using multiple measures of earnings quality and managerial ability, we report that earnings quality is negatively associated with managerial ability. We also find that a strong system of investor protection mitigates this negative relation. Overall, our study adds to the literature on the impact of managerial characteristics on financial reporting decisions.

Keywords: Managerial ability, Data Envelopment Analysis, Earnings quality, Legal environment, Real earnings management
1. Introduction

In this paper, we use a cross-country setting to examine the relation between managerial ability and earnings quality. Prior research based on U.S. firms provides mixed evidence on this relation. One set of papers finds a negative relation between managerial ability and earnings quality. Francis et al. (2008) show that more reputed CEOs report poorer earnings quality. Malmendier and Tate (2009) document that superstar CEOs are more likely to inflate reported performance via earnings management and attribute this result to pressure to meet the market’s expectation of “superstar performance”. These results are consistent with the view that the pressure on high ability managers to consistently report good performance leads to low quality financial reporting. An alternative interpretation for these findings is that firms with poor earnings quality require the superior talents of more reputed CEOs (Francis et al. 2008). In contrast to prior research, Demerjian et al. (2012a, 2012b), use a new measure of managerial ability drawn from Data Envelopment Analysis (DEA) and provide evidence suggesting that more able managers report high quality earnings because they have the skill to synthesize corporate information into reliable forward looking estimates, as reflected in accrual decisions.

Our cross-country study provides a powerful setting to examine the relation between managerial ability and earnings quality because there is greater heterogeneity across countries than within countries in variables that determine earnings quality, such as legal systems (Dechow et al. 2010). LaFond (2008) calls for international evidence on the relation between managerial ability and earnings quality and also questions whether managers’ real decisions or accounting choices drive the association between CEO ability and earnings quality. We therefore also examine the relation between managerial ability and real earnings management, which involves

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1 Prior research defines a manager’s reputation as the market’s perception of her ability (Fama 1980; Milbourn 2003). We use the terms managerial ability and managerial reputation interchangeably throughout the paper.