



Regulations, institutions and income smoothing by managing technical reserves: International evidence from the insurance industry[☆]



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ARTICLE INFO

Article history:

Received 7 July 2014

Accepted 16 May 2015

Available online 10 June 2015

Keywords:

Earnings management

Income smoothing

Insurance

Technical reserves

ABSTRACT

This paper investigates the role of technical reserves in the income smoothing behavior of insurance companies. This is one of the first attempts in the literature to trace such relationship in the insurance industry, especially at a multi-country setting. The experience of 770 insurance firms operating in 87 countries over the period 2000–2009 reveals that there is a significant evidence of income smoothing. The paper also finds that institutional characteristics, e.g., the rule of law, common law legal origin, economic freedom, and regulations relating to technical provisions and supervisory power constrain income smoothing but other factors such as capital requirements, tax deductibility of provisions, auditing, and corporate governance do not have a significant effect.

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1. Introduction

Practitioners and academics have recognized for years that managers have the incentives and the ability to use latitude in accounting rules in order to determine the figure printed in the earnings report for a particular period. This allows them to avoid reporting losses or profit decreases, a practice known as income smoothing or earnings management. Healy and Wahlen [34] in a review of the literature state that “In general, the evidence is consistent with firms managing earnings to window-dress financial statements prior to public securities’ offerings, to increase corporate managers’ compensation and job security, to avoid violating lending contracts, or to reduce regulatory costs or to increase regulatory benefits” (p. 367).

The importance of earnings management lies on the fact that various stakeholders (e.g. investors, creditors, regulators, etc.) use financial statements to make more informed decisions. However, in cases of excessive manipulation, the decision makers can no longer rely on the financial statements and evaluate the financial position and the operating performance of the firm. Additionally, financial misrepresentation can be extremely costly for shareholders and individual offenders. For example, Karpoff et al. [42] document that

while the penalties imposed on firms through the legal system average only \$23.5 million, firms also lose 38% (on average) of their market values when news of their misconduct are reported¹. Ge and Kim [29] focus on the cost of new bond issues in the U.S. to conclude that bondholders perceive real earnings management as a credit risk-increasing factor and thus require high risk premiums. In another study, Karpoff et al. [43] show that while fewer than one out of three managers face criminal charges and penalties, a substantial proportion (93%) lose their jobs by the end of the regulatory enforcement period, and they also bear substantial financial losses through restrictions on their future employment, their shareholdings in the firm, and SEC fines. Therefore, it is not surprising that this topic has attracted the attention of numerous researchers who have related earnings managements to market power [12], marketing actions [8], management buyouts [22], and analysts’ forecast accuracy [55], to name a few. Recent efforts have also been directed towards the development of quantitative models for the detection of earnings management [69,16].

The present study aims to extend the existing literature while focusing on the insurance industry². As discussed in Eckles and

¹ A recent report by Cornerstone Research [10] also indicates that accounting cases corresponded to the vast majority of the total value of class action cases settled over the period 2004–2012, ranging between 73% (2011) and 97% (2006).

² The insurance industry has traditionally attracted academic attention with studies focusing on various topics like intellectual capital and performance [56], organization and efficiency [5], insurance claims decisions [7], optimal premium pricing strategies [60].

[☆] This manuscript was processed by Associate Editor Michael Doumpos.

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Halek [20] insurance firms have not been exempt from scandals related to accounting manipulations in order to meet earnings goals, with AIG being a notable example. An interesting aspect of the insurance industry is that company executives have at least one accounting accrual at their discretion, namely technical provisions. These provisions represent amounts set aside by the firms to meet potential liabilities arising out of insurance contracts. Therefore, fair provisioning is of great importance for managers, regulators and other stakeholders³. However, an insurer's reserves are at best only a forecast of future payments for outstanding claims, and there are various methods available to estimate technical provisions (e.g. case-by-case, statistical and actuarial methods). Yet, while the uncertainty in the estimation of technical reserves affects the various stakeholders of an insurance firm, and it has the potential to greatly influence the solvency position of the firm, the nature and extent of this uncertainty is generally not well understood [47].

Our first objective is to use a cross-country sample of insurers and analyze whether the managers of insurance firms engage in income smoothing by managing technical reserves, at an international level. Existing empirical evidence from the insurance industry is limited (compared to other industries), and comes from country-specific studies, mainly U.S. ones. Nonetheless, institutional and regulatory differences across countries, do not allow us to generalize the results of such country-specific studies, and we aim to close this gap in the literature by using an international sample.

Our second objective is to examine the effect of the business conditions, and in particular the regulatory and institutional environment, on technical reserves and income smoothing. Apparently, earnings management depends upon both the means and the incentives that managers have at their disposal. In the case of the insurance industry, these attributes depend not only on the overall institutional framework of a country but also on specific regulations that govern the insurance industry. One would expect that opportunities for earnings management decrease in a stricter regulatory environment. As we discuss in more detail in Section 2, some recent studies that examine non-financial sectors and the banking industry document that regulations and institutions influence the managerial decisions with respect to provisioning and earnings management (e.g. [51,66,23]). However, no such evidence exists for the insurance industry.

Our results show that insurance firms use technical reserves to smooth their income. We find that control of corruption, and the regulatory quality do not influence income smoothing; however, the rule of law, and common law regimes have mitigating effects. Two overall institutional development indicators, namely economic freedom and economic development also appear to constrain income smoothing. Higher stringency in regulations relating to technical provisions, along with supervisory power seem to constrain income smoothing, whereas capital requirements, the taxation framework for provisions, auditing, and corporate governance and internal control mechanisms do not have a significant impact on income smoothing. Surprisingly, disclosure requirements related to technical provisions have a positive effect on income smoothing.

Our findings could be of interest to various stakeholders. For example, our multi-level model reveals that 50.6% of variation in technical reserves can be explained by differences across firms, whereas differences across countries account for 41.7%. The first should be of interest to internal auditors who may want to

understand what drives technical reserves or to use audit analytics to detect earnings management in their firm. The variation across countries could be of interest to policy makers in the insurance industry, as regulations appear to have an important impact on technical reserves and earnings management. Within this context, our findings could also form the basis for the development of models for the detection of earnings management, an area of research that relates to audit analytics and the detection of falsified financial statements (see e.g. [62,24]). While the development of such a model does not fall into the scope of the present study, other researchers could incorporate some of the variables that we find to be related to earnings management (e.g. regulations relating to technical provisions) in their models, and test whether they improve their prediction ability⁴. Subsequently, such models could be used by either external or internal auditors.

The rest of the paper is structured as follows. Section 2 provides a review of the related literature. Section 3 presents the variables and the methodology. Section 4 discusses the empirical results. Section 5 concludes.

2. Brief literature review

Our work is broadly related to three strands of the literature. The first consists of studies that provide evidence from the U.S. insurance industry. For example, Petroni [63] finds that managers of financially weak U.S. insurance firms bias downwards estimates of claim loss reserves relative to financially strong insurers. This finding is stronger for firms "close" to attracting regulatory attention. Beaver et al. [2] also find that property-casualty insurance firms with small positive earnings understate loss reserves relative to firms with small negative earnings. Gaver and Paterson [27] provide country-specific evidence on the association between the loss reserves practices and state regulatory quality in the US. They find that under-reserving by financially weak insurers declined after the National Association of Insurance Commissioners instituted a program for accrediting states that met certain standards in terms of insurance regulation. In another U.S. study, Gaver and Paterson [28] report that insurance firms manage loss reserves to avoid violating certain test ratio bounds that are used by regulators for solvency assessment.

The second strand of the literature consists of cross-country studies that highlight the role of institutional and regulatory factors while focusing on banking as well as non-financial firms. For instance, using a sample of non-financial firms across 31 countries, Leuz et al. [51] find that a country's legal and institutional environment influences the properties of reported earnings. In another study that considers non-financial firms from Australia, France, and the UK, Jeanjean and Stolowy [40] conclude that management incentives and national institutional factors play an important role in framing financial reporting characteristics, and this role is probably more important than accounting standards alone. Shen and Chih [66] provide evidence from the banking sector. Using data from 48 countries they find that stronger protection of investors and greater transparency in accounting disclosures can reduce banks' incentives to manage earnings. They also report that stronger law enforcement results in more earnings management; however this effect is observed in low-income countries only. Fonseca and Gonzalez [23] also consider the impact of institutions, but most importantly they investigate the effect of bank regulations on income smoothing. They find that there is less bank income smoothing not only with the strength of investor protection, but also with the extent of accounting disclosures, restrictions on bank activities, and official and priv-

³ For example, technical reserves form an important part of Pillar I in Solvency II, the new regulatory framework that will be implemented in the Europe Union. In the United States, the Securities Exchange Commission (SEC) increasingly requests additional disclosures regarding reserve uncertainty, while the International Association of Insurance Supervisors—IAIS (2005) highlights that "technical provisions have to be prudent, reliable, and objective and allow comparison across insurers worldwide" (p. 10).

⁴ For example, Tsai and Chiou [69] provide such an exercise using a sample of listed Taiwanese firms from the electronics industry.

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