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Earnings management to exceed thresholds in continental and Anglo-Saxon accounting models: The British and French cases

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ABSTRACT

The purpose of this paper is to compare the extent to which French and British firms manage their earnings in order to avoid losses, decreases in earnings and earnings below the forecasts of analysts. Further, this study aims to investigate the factors that potentially influence earnings management to exceed thresholds with reference to the Anglo-Saxon and continental accounting models. Britain and France, correspondingly, belong to those different socio-economic environments. Based on a panel data of 1771 French and 2057 British firm-year observations during the period 2002–2012, we show that all firms considered manage earnings to beat zero and last year's earnings. However, earnings management in order to meet analysts' forecasts appears to be more prevalent in British firms. Considering earnings management incentives, we find that firm size has a positive effect for all thresholds considered. Similarly, the signaling hypothesis is more evident for British firms for all thresholds examined. The corporate governance structure is also found to impact the extent of earnings management.

1. Introduction

A growing literature supports the idea that differences in market integrity and culture between countries influence the earnings management (Cieslewicz, 2014; Papanastasopoulos, 2014). Leuz et al. (2003) note that earnings management propensity depends on the institutional contexts in which accounting earnings are used. In Common Law countries, shareholder economy prevails and the purpose of standard setting is to satisfy the information needs of investors because the main source of companies financing is the financial markets (Burgstahler et al., 2006). Given the importance of financial market for Anglo-Saxon firms, investors and financial analysts' interests weigh heavily on these firms. In this context, managers have incentives to present positive and increasing earnings to maximize firm value and attract more investors (Habib and

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Hansen, 2008). In Code Law countries, stakeholder economy is prevailing and accounting serves as a measure to divide profits between stakeholder groups. The accounting system of these countries is characterized by the strong "legislative" tradition, the strong link between accounting and taxation and the limited influence of the accounting professionals. These features are explained by the fact that firms significantly recourse to bank financing and that the state is the primary recipient of the financial statements (Gomariz and Ballesta, 2014). As pointed out by Van Tendeloo and Vanstraelen (2008), these countries are less incited to supply minority shareholders with information and try rather to inform banks. Given the importance of banks as block shareholders, managers have to satisfy bank interests and especially solvency. Thus, reporting positive and increasing earnings allows firms to maintain good relations with banks and insure them about solvency.

Accordingly, earnings management behavior and motives will be affected by specific features of the Anglo-Saxon and continental environments. Previous studies have addressed earnings management issue in international context. In these studies earnings management is commonly examined using discretionary accruals (Leuz et al., 2003; Ahmed et al., 2013), specific accruals (Dechow et al., 2010), earnings smoothing (Barth et al., 2008; Ahmed et al., 2013) or positive earnings threshold (Barth et al., 2008; Gilliam et al., 2015). This latest measure, which is evidence of earnings management to avoid reporting losses, is one threshold among others founded in earnings distribution. Burgstahler and Dichev (1997), Degeorge et al. (1999) and Burgstahler and Eames (2006) have provided evidence of earnings management to meet and beat two other thresholds: last year's earnings and analysts' earnings forecasts. Recent studies tend to use earnings distributions methodology as in Burgstahler and Dichev (1997) to determine if firms manage accounting figures to publish earnings in compliance with psychological thresholds. This approach is based on the fact that if earnings are managing according to certain psychological thresholds, earnings distribution has to present anomalies, such as when there are unusually few companies publishing earnings just below these thresholds and when there are unusually many companies publishing earnings just above these thresholds.

The current accepted idea among accountants, regulators and standard setters is that, more often than not, earnings management constitutes an inverse measure of earnings quality (Ahmed et al., 2013). In particular, consistent with prior international studies, accounting choices that result in greater management of earnings to meet a target is interpreted as reducing accounting quality (Chen et al., 2010; Jia, 2013). Or, as noted by Habib and Hansen (2008), a majority of the academic research on benchmark beating considers an opportunistic perspective of earnings management and gives less consideration to signaling one. This alternative motivation for exercising earnings discretion suggests that managers use earnings management to signal their private information about future firm prospects.

In line with these previous studies, our research examines earnings management thresholds frequency and incentives with reference to continental and Anglo-Saxon accounting models. France and Britain, respectively, belong to those different socio-economic environments. Our choice of these two European countries is motivated by their heterogeneity; they have different financial and legal systems and are characterized by noticeable institutional diversity. For example, the accounting system in France is marked by a conceptual framework that satisfies stakeholders' information needs, and the accounting earnings are linked to a large extent to fiscal rules. In contrast, the conceptual framework in British accounting system safeguards shareholder interests, and this made the disconnection between tax and accounting. Ding et al. (2003) note that France is generally depicted in the literature as a key representative of the continental accounting model. On the other hand, Great Britain is the main European country using Anglo-Saxon accounting system. Since the institutional and financial situations of a country largely determine the quality of accounting information, it is likely that institutional and financial factors will impact the earnings management incentives. Moreover, because earnings management thresholds depend on accounting standards flexibility, it is interesting to perform a robustness check to test whether its frequency and motives changes with mandatory IFRS adoption for European firms. Since IFRS are recognized for higher quality standards, it is plausible that they will affect earnings management motives.

Based on a panel data of 1771 French and 2057 British firm-year observations during the period 2002–2012, we show that all firms considered manage earnings to beat zero and last year's earnings. Analyst forecast threshold is more prevalent for British firms. Considering earnings management incentives, using static and dynamic panel estimations, we find that firm size has a positive effect for all thresholds considered. Similarly, the signaling hypothesis is more evident for British firms for all thresholds examined. The findings also indicate that some corporate governance factors impact the extent of earnings management to exceed thresholds. Further, we note that the mandatory adoption of IFRS does not constraint earnings management thresholds.

Our study extends previous research on earnings management in several significant ways. First, while prior studies usually use accruals models to measure directly the amount of financial reporting discretion for managers, we use the distribution approach which provides a basis for doing so in future studies. Second, this study complete existing earnings management literature as we find that institutional differences between continental and Anglo-Saxon accounting models affect earnings benchmark beating frequency and incentives. Third, it is the first study to provide evidence of benchmark beating incentives in French and British contexts. While the majority of earnings management studies examine and validate opportunistic incentives, our results validate signaling incentives for British firms. Finally, this paper adds to the existing literature on IFRS by investigating the effects of IFRS adoption on earnings management around thresholds.

The remainder of the paper proceeds as follows. Section 2 outlines the relevant literature and presents research hypotheses. In the third section, we develop methodology pursued for empirical research. The fourth section reports results and the robustness check. Final section presents concluding remarks.