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The Impact of Accounting Disclosures and the Regulatory Environment on the Information Content of Earnings Announcements☆

Lisa A. Eiler[a,*], Jose Miranda-Lopez[b], Isho Tama-Sweet[a]

[a] *Mihaylo College of Business and Economics, California State University, Fullerton, Fullerton, CA 92834, USA*
[b] *Collins College of Business, University of Tulsa, OK 74104, USA*

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Abstract

We investigate how accounting standards and the regulatory environment influence the usefulness of accounting information. Prior research finds no market reaction to earnings announcements in Mexico during the late 1990s. However, beginning in 1999, a series of regulatory changes required firms' compliance with a governance code and mandated electronic quarterly reporting. Additionally, in 2007 Mexico reissued their accounting standards to converge toward IFRS. We hypothesize that the market reacts to earnings announcements following the implementation of these changes in the reporting environment. Our results support our hypothesis. We also hypothesize and find evidence of a price reaction to earnings announcement for most share classes, and a volume reaction to earnings announcements for all share classes. Finally, we find support for our hypothesis that the firm's information environment affects the market reaction to earnings announcements. Overall, our findings suggest that the information content of earnings announcements has increased in the new reporting environment.

Keywords: Information content; Emerging markets; Market reaction; Mexico
JEL classification: G14; G15; G34; G38

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* Corresponding author. Tel.: +1 657 278 3835; fax: +1 657 278 4518.
E-mail address: leiler@fullerton.edu (L.A. Eiler).

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1. Introduction

Evidence from cross-country studies indicates that accounting standards, managerial incentives, and the regulatory environment largely determine national-level financial reporting quality (e.g., Ball, Robin, & Wu, 2003; Bushman & Piotroski, 2006; Hail & Leuz, 2006; Leuz, Nanda, & Wysocki, 2003).[1] Mexico provides an interesting setting to examine the usefulness of accounting information following a series of changes to the financial reporting system and corporate governance structure. In this paper, we examine the market reaction to earnings announcements in Mexico following changes to accounting standards and the regulatory environment. Given that prior literature (i.e., Bhattacharya, Daouk, Jorgenson, & Kehr, 2000; Prather-Kinsey, 2006) finds no market reaction at the announcement date of annual earnings and other news in Mexico, our study provides evidence on whether these changes have influenced the usefulness of accounting information. More broadly, our study seeks to increase our understanding of how changes in accounting standards, disclosure, and governance influence the behavior of market participants.

Bhattacharya et al. (2000) investigate the short-window market reaction to a variety of news events including dividend, merger, and annual earnings announcements for firms listed on Mexico's primary stock market, the *Bolsa Mexicana de Valores* (hereafter the *Bolsa*). Using data from the mid-1990s, they find no market reaction around the announcement date of news events. They conclude that insider trading has incorporated earnings and other news into price before the announcement, and thus there is no market reaction at the announcement date. Prather-Kinsey (2006) focuses on the price reaction to annual earnings announcements for firms listed on the *Bolsa* from 1998–2000. She finds no evidence of abnormal returns around earnings announcements. Taken together, the results of these studies suggest that the prevalence of insider trading reduces the information content of earnings announcements in Mexico.

However, from 1999 through 2006, Mexican officials implemented several interrelated changes to financial reporting and the regulatory environment. To improve corporate governance, firms were required to increase the percent of independent board members, and the voting capital required to call a meeting decreased from 25% to 10%.[2] In addition, financial reporting frequency increased from an annual to a quarterly basis (Familiar Calderón, 2003). Concurrently, regulations compelled firms to file financial reports electronically with the *Bolsa*. As with the EDGAR system in the United States, electronic reporting allows for timely, low-cost access to financial reports for all investors (World Bank, 2003).

Following the governance changes and increase in reporting frequency, Mexico issued a revised set of accounting standards that were implemented in 2007. The revised standards were designed to converge Mexican GAAP toward IFRS, in preparation for complete

[1] We use the term regulatory environment throughout this paper to refer to the various country-specific factors such as the political and legal environments, as well as the strength of institutions and enforcement.

[2] Specifically, in 1999, Mexican officials drafted a best practices corporate governance code. Compliance with the governance code was initially voluntary; however, in June of 2001, portions of the governance code became enforceable. In 2003, the *Comisión Nacional Bancaria y de Valores* (CNBV) issued the *Circular Única de Emisoras* (*Circular Única*, or CU). The CNBV is the Mexican National Banking and Securities Commission, which is comparable to the US Securities and Exchange Commission. It is tasked with regulating and enforcing capital market and banking activity. The CU updated the 1975 Security Market Law (*Ley del Mercado de Valores*), and required more complete compliance with the new governance code.