



## Earnings attributes and investor-protection: International evidence<sup>☆</sup>

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### Abstract

This study explores the effects of investor-protection on reported earnings quality assessed on the basis of four accounting-based earnings attributes (accruals quality, earnings persistence, earnings predictability, and earnings smoothness). We test the hypothesis that favorable values of each earnings attribute (considered individually) occur in countries whose institutional characteristics provide relatively strong investor-protection. The results based on K-means cluster analysis of institutional characteristics are mixed. Earnings smoothness is less prevalent in strong investor-protection countries, as hypothesized. However both accruals quality and earnings predictability are better in countries whose institutional characteristics are relatively weak. No association is found between investor-protection and earnings persistence, except that countries with low ownership concentration appear to have high earnings persistence. The results based on regression analysis are consistent with those based on the cluster analysis. These results imply that conclusions about the impact of institutional characteristics on earnings quality depend on how earnings quality is measured.

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**Keywords:** Earnings quality; Earnings attributes; Investor-protection; Accruals quality; Earnings persistence; Earnings predictability; Earnings smoothness

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<sup>☆</sup> Data availability: the data used in this study are publicly available.

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## 1. Introduction

A major motivation for accounting research is providing evidence on the usefulness of earnings. Of particular interest in recent years has been the quality of accounting reports, particularly the quality of earnings. In September 1998 Arthur Levitt, then Chairman of the Securities and Exchange Commission (SEC), presented “The Numbers Game” at New York University, in which he highlighted the escalating problem with the quality of financial reporting in filings with the SEC. Accounting quality has also received a great deal of attention following a significant increase in the incidence of earnings restatements (GAO, 2003), several high-profile bankruptcy filings by firms accused of accounting irregularities (e.g., Worldcom and Enron), and the demise of Arthur Andersen.

Earnings quality is of major importance to users of financial information as well as to practitioners, regulators, and accounting researchers since earnings is widely believed to be the premier information item provided in financial statements (Lev, 1989). Schipper and Vincent (2003) contend that poor earnings quality is detrimental to investors and other financial statement users. Low-quality earnings can lead to a misallocation of capital and may also generate inappropriate outcomes for contracts that use accounting data as inputs.

Teets (2002) suggests that earnings quality is influenced by prevailing standards as well as by managers’ accounting choices. Since managerial discretion plays an important role in financial reporting, several international studies (e.g., Ali & Hwang, 2000; Ashbaugh & LaFond, 2003; Ball, Kothari, & Robin, 2000; DeFond, Hung, & Trezevant, 2004; Hung, 2001; Leuz, Nanda, & Wysocki, 2003) have examined whether differences in the properties of earnings across countries are associated with the legal protection afforded outside investors from expropriation by controlling shareholders or managers.

The extent of investor-protection varies greatly around the world. Shleifer and Vishny (1997) state that in some countries such as the United States, Japan, and Germany, the law protects the rights of at least some investors and the courts are relatively willing to enforce these laws. But even in these countries, the legal system leaves managers and controlling owners with considerable discretion to manage reported earnings in order to mask true firm performance and to conceal their private control benefits from outsiders. In most of the rest of the world, the extent of investor-protection is less and the judicial system works less well as courts consider only the clearest violations of investor rights. As a result, legal protection alone becomes insufficient and accounting information such as earnings cannot reflect “true” economic performance.

Previous research related to a linkage between investor-protection and earnings quality is relatively scarce. Most prior studies have focused on the effect of investor-protection on earnings management (Leuz et al., 2003), value relevance of earnings (Ali & Hwang, 2000; Hung, 2001), and informativeness of reported earnings (Ball et al., 2000). Leuz et al. (2003) find less earnings management in countries with stronger investor-protection. Bhattacharya, Daouk, and Welker (2003) find that an increase in overall earnings opacity in a country is linked to an increase in the cost of equity and a decrease in trading in the stock market of that country. Ali and Hwang (2000) document that earnings in the United States is more value relevant than earnings in other countries because of the differences in country-specific factors. Hung (2001) concludes that shareholder protection improves the effectiveness of accrual accounting. Ball et al. (2000) document that an important difference

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