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Financial reporting quality in international settings: A comparative study of the USA, Japan, Thailand, France and Germany

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Abstract

The purpose of this study is to show the importance of the business contexts of individual countries to understand corporate accounting practices in international settings. Using data from five countries, we show that while agency theory constructs are effective in explaining accounting practices in corporate settings that have a strong agency orientation, such as that of the United States, it is necessary to go beyond such constructs to understand accounting practices in other corporate settings. Given the variety of international business settings, we use a generic theory, institutional theory. To conduct this examination into cross-country accounting practices, we focus on an earnings quality measure based on accrual accounting practices, the abnormal accruals component of accounting earnings. We provide evidence to support the view that with varying business settings we are likely to see diversity in accounting practices that result in different levels of accruals or accruals based earnings quality.

Keywords: Agency theory; Financial reporting quality; USA; Japan; Thailand; France; Germany

1. Introduction

Agency theory is frequently used by researchers to explain accounting practices in country-specific studies. It explains accounting practices in corporate settings that have a

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strong agency orientation as it is based on the notion of separation among ownership, debt, and management. For example, studies focused on the United States usually support the agency argument that certain firm and board features, and good quality accounting[1] and auditing are the bases for better firm performance. However, in international settings, similar studies have often produced contradictory results. For example, Gabrielsen, Gramlich, and Plenborg (2002) find that managerial ownership (an agency variable) has different effects on the information content of earnings and discretionary accruals in Denmark from that in the United States. Further, in a review of audit independence, discretionary accruals, and earnings-informativeness studies, Rainsbury (2007) finds that in many non-U.S. settings agency monitoring mechanisms such as board of directors, accounting arrangements, and audit quality do not relate to discretionary accruals and earnings informativeness in the same manner as they do in the US setting.

Agency theory originated in the environment of growth of large modern corporations in Anglo-American countries. It mainly focuses on exogenous factors that relate to financing. However, the business settings internationally are diverse in characteristics. The purpose of this study is to emphasize the need to go beyond the agency theory constructs to explain accounting practices in international settings and to propose the use of a generic and all-encompassing theory, institutional theory, which is applicable to all international settings, with or without strong agency orientation. Institutional theory allows for the examination of all exogenous and endogenous factors that affect corporate practices.

We do not see, however, agency theory and institutional theory as mutually exclusive. Rather, we see agency theory as a theory that is applicable to an institutional setting where the agency relationships among ownership, debt, and management are clearly explicable. In other words, agency theory constructs are better applicable to explaining corporate actions in settings where there is clear separation among ownership, debt, and management. On the other hand, institutional theory is a more general theory that calls for an appreciation of any form of institutional arrangement prevailing in business.

Institutional influences on accounting have been observed in the extant literature. For example, Ball (1995) and Nobes (1998) contend that accounting systems and the level of market transparency are functions of the nature of the legal systems and financing of firms in a country. This view has been broadly assessed in terms of whether a country has a code-law or a common-law legal origin, or whether a country has a debt-based or an equity-based capital market (Ball, Kothari, & Robin, 2000; Ali & Hwang, 2000; Ball, Robin, & Wu, 2003). However, it only provides a general understanding of how accounting is related to law and finance and lacks appreciation of the specific nature of country settings and their influence on accounting practices in international settings. For example, Ball et al. (2003) find that the timeliness of accounting income in four East Asian common-law countries is similar to the timeliness of accounting income in code-law countries, suggesting that there are other factors affecting accounting income.

The financial and organizational settings of countries are far more complex than what the legal and financing dichotomies reflect. For East Asian countries, Fan and Wong (2002) find that concentrated ownership and the associated pyramidal and cross-holding structures

[1] For the purposes of this study, accounting quality is defined as the extent to which accounting indicators are reliable measures of firm performance.