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A cross-country study of legal-system strength and real earnings management

Bill Francis^a, Iftexhar Hasan^{b,d,*}, Lingxiang Li^c

^a Lally School of Management, Rensselaer Polytechnic Institute, 110, 8th Street, Troy, NY 12180, United States

^b Gabelli School of Business, Fordham University, 45 Columbus Avenue, 5th Floor, New York, NY 10023, United States

^c School of Business, State University of New York–Old Westbury, 223 Store Hill Rd, Old Westbury, NY 11568, United States

^d Bank of Finland, Helsinki 00101, Finland

A B S T R A C T

This paper investigates how firms' real-activities-based earnings management (RM) varies with the strength of a country's legal environment. Using cross-country data and multiple research designs, we reveal that RM increases with country-level legal strength. On the contrary, the paper reports that stronger legal system discourages accrual-based earnings management (AM). The overall evidence strongly suggests that legal environment plays a crucial role in firm's choice of earning management technique.

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1. Introduction

The prior accounting literature has recognized that a country's legal system influences firms' financial reporting behaviors (e.g., Ball et al., 2000; Francis and Wang, 2008; Fung et al., 2013; Haw et al., 2004; Leuz et al., 2003). Among these cross-country studies, Leuz et al. importantly demonstrate that countries with stronger legal systems display less accrual-based earnings management.¹ For example, the U.S. is shown to have the lowest level of earnings management in their study. However, a later survey

* Corresponding author at: Gabelli School of Business, Fordham University, 45 Columbus Avenue, 5th Floor, New York, NY 10023, United States.

E-mail addresses: francb@rpi.edu (B. Francis), ihasan@fordham.edu (I. Hasan), lil@oldwestbury.edu (L. Li).

¹ Haw et al. (2004) use *discretionary accruals* as their measurement of earnings management. The measurement in Leuz et al. (2003) is from the aggregation of four earnings management constructs, three of which are based on accruals. The non-accrual one is defined as the number of "small profit" divided by the number of "small loss" for each country. This ratio could be affected by both AM and RM.

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by [Graham et al. \(2005\)](#) suggests that managers in the U.S. actually rely more on real operations than accruals to manipulate earnings (hereafter, AM and RM).² Taken together, these findings make us wonder whether the less AM in stronger legal systems actually comes at the expense of more RM as substitute.

While firms' financial reporting needs to conform to accounting standards, their real operating decisions are largely left to managers' discretion. Each firm faces its own unique circumstances, making opportunistic RM rather difficult to prove in court. Here is an illustration of the heavy burden of proof: in a recent class-action lawsuit brought by the shareholders against Tellabs, Inc., one of the allegations is that the company has continuously engaged in channel stuffing to make their earnings look better. Regarding this allegation, Judge Richard Posner provided the following explanation:

In a securities action, a certain amount of channel stuffing could be innocent and might not even mislead – a seller might have a realistic hope that stuffing the channel of distribution would incite his distributors to more vigorous efforts to sell the stuff lest it pile up in inventory. In sum, such practices are neither inherently fraudulent nor always innocent; size, design, purpose, transparency, and history are all relevant

[Tellabs Inc. v. Makor Issues & Right, 2007]

The three RM activities that receive the most attention in the literature are manipulations in discretionary expenses, production levels, and sales strategies. To the best of our knowledge, there was no historical SEC allegations of manipulation in production levels or discretionary expenses.³ We do find some SEC enforcement actions and shareholder lawsuits against “channel stuffing,” which is a typical example of RM in sales.⁴ However, in most “channel stuffing” cases, the main allegations are still concerned with GAAP violations.

Together, the above examples suggest that the court systems and regulatory frameworks generally do not have effective mechanisms to address RM even in strong legal systems. In comparison, the discipline over AM is known to be more effective in stronger legal systems. Therefore, from managers' perspectives, an increase in legal-system strength is likely to raise the cost of AM but not of RM, resulting in a decrease of the relative cost of RM over AM. This rationale predicts that firms' engagement in RM increases with country-level legal strength. Our empirical results strongly support this prediction.

There are not many empirical studies that directly examine the relationship between earning management and legal systems.⁵ Among them, [Leuz et al. \(2003\)](#) find that earnings management is less severe in countries with stronger legal systems and better protections of minority shareholders.⁶ They argue that, when protection of outside investors is stronger, insiders extract fewer private control benefits. Consequently, they need less earnings management to hide the true performance. This argument would predict that both RM and AM decrease with legal strength. [Haw et al. \(2004\)](#) look at the role of legal and extra-legal institutions in limiting the type of earnings management that arises from the separation of controlling shareholders' cash-flow rights and control rights. They find that the strength of those institutional factors is negatively associated with this type of earnings management. Both studies heavily rely on accounting accruals to measure earnings management. We believe it is important for us to revisit the same issue, but with RM, before one can draw a conclusion about the impact of legal system on earnings

² Empirically, [Roychowdhury \(2006\)](#) shows that U.S. firms cut discretionary expenses, overproduce, and manipulate actual sales to reach earnings targets.

³ For example, out of the 92 SEC enforcement actions against earnings overstatement in [Dechow et al. \(1996\)](#), none is related to discretionary expenses (including advertising and R&D) or production level.

⁴ For example, a simple search of the key word “channel stuffing” yields 82 results in SEC/AAER and 77 results in *Stanford/Securities Class Action Clearing House*. In their detailed study of channel stuffing, [Das et al. \(2012\)](#) finds about 102 publicly traded firms with accounting irregularities associated with channel stuffing. Differently, sales manipulation seems to receive a fair amount of attention from shareholders and legal authorities. This is one of the reasons why we do not use the RM proxy *Abn_CFO*, which measures abnormal sales.

⁵ There are some other empirical studies that examine the relations between earnings characteristics and institutional factors: [Ball et al. \(2000\)](#) (timely incorporation of future income information); [Ali and Hwang \(2000\)](#) (value relevance of financial data); [Hung \(2001\)](#) (the effects of accrual accounting versus cash accounting on value relevance in different countries); [Francis and Wang \(2008\)](#) (joint effects of auditing firm and country-level investor protection on earnings quality); [Angelos and Antzoulatos \(2014\)](#) (institutions and moral hazard).

⁶ Minority shareholder rights are sometimes referred to as outside investor rights. We use these two terms interchangeably throughout the text.

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