Advances in Accounting, incorporating Advances in International Accounting xxx (2013) xxx–xxx

Contents lists available at SciVerse ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

Do analysts follow emerging economy firms with higher intangible assets? Empirical evidence from Egypt

Mohamed A. Elbannan *

Department of Accounting, Faculty of Commerce, Cairo University, Orman, Giza 12316, Egypt
Department of Accounting, School of Business, American University in Cairo, New Cairo, Cairo 11835, Egypt

ARTICLE INFO

Available online xxxx

Keywords:
IAS 38
Analyst coverage
Intangible assets
Analyst effort
Egypt

ABSTRACT

This paper tests whether analyst coverage and effort are related to the level of intangible assets reported by Egyptian listed firms. Intangible assets represent increasingly important investments for many firms, but most of these assets are not capitalized under prevailing accounting standards. Analysts reduce the information asymmetry by examining both financial reports and other information. Many Egyptian firms today seek access to foreign capital. I hypothesize that the larger the potential intangible assets of firms the more analysts will cover these firms and pursue private information about these firms. Sample consists of 435 firm-year observations over the period 1999–2007, and intangible assets are measured using eight different firm- and industry-level proxies. Consistent with prior research, results suggest that coverage is significantly associated with firm R&D, industry advertising expenses, firm size, and trading volume. Results also suggest that analyst effort is a function of firm and industry-level R&D expenses and firm size.

1. Introduction

This paper examines whether analyst coverage is associated with unrecorded intangible assets reported by Egyptian firms. Intangible assets reflect future economic benefits from knowledge-based activities, but may be a source of information asymmetry between managers and investors due to the current accounting requirements. Absent information intermediaries, such as analysts, share prices of firms with substantial intangibles would be less accurate (Barth, Kasznik, & McNichols, 2001). Analysts are motivated by an opportunity to generate profitable investment recommendations and higher trading commissions. In this context, emerging markets warrant special attention for two reasons. First, the inherent institutional imperfections characterizing these markets increase the need for the services of intermediaries. Second, transparent reporting serves the needs of emerging market firms that aggressively seek international investors who increasingly require transparent disclosures (Chang, Khanna, & Palepu, 2000).

Along these lines, this study focuses on analyst coverage of listed Egyptian firms who report intangible assets. In particular, I predict that analysts are more likely to cover firms with relatively higher unrecorded intangible assets, and that analysts expend greater effort to cover firms with more intangible assets. To test the first prediction, analyst coverage is empirically modeled as a function of a set of firm- and industry-level proxies for intangible assets, such as R&D and brand names. To test the second prediction, analyst effort is empirically modeled as a function of the same set of proxies and control variables, with analyst coverage as an additional determinant of effort.

The sample consists of 435 firm-years related to 54 Egyptian firms listed on the Egyptian capital markets during the period 1999–2007. Results are consistent with the hypothesis that analyst coverage of firms listed on Egyptian capital markets is a function of unrecorded intangibles reported by listed firms, and with prior research findings using U.S. and international samples. Significant relations were found between analyst coverage and firm-level R&D expenses, industry-level advertising expenses, analyst effort, firm size, and trading volume. There is also some evidence that change in coverage is motivated by a decline in firm risk, measured by earnings variability. Results are also consistent with the hypothesis that analyst effort is a function of unrecorded intangibles. Significant relations were found between analyst effort and firm- and industry-level R&D expenses, analyst coverage and firm size. There is also some evidence that change in effort is a function of the change in earnings variability, indicating that analysts expend more effort following firms when fluctuations in their earnings decline. The insignificant results and divergences from extant research could be explained by the different settings exploited in this study.

This study contributes to two streams of literature: intangible assets and analyst activity. To the first, it provides country-specific evidence on the economic effects of expensing intangibles on analyst coverage in an emerging economy. To the second, it documents that

* Tel.: +20 2 2615 3270; fax: +20 2 2792 3847.
E-mail address: melbannan@aucegypt.edu.

0882-6110/$ – see front matter © 2013 Elsevier Ltd. All rights reserved.
http://dx.doi.org/10.1016/j.adiac.2013.03.010

Please cite this article as: Elbannan, M.A., Do analysts follow emerging economy firms with higher intangible assets? Empirical evidence from Egypt, *Advances in Accounting, incorporating Advances in International Accounting* (2013), http://dx.doi.org/10.1016/j.adiac.2013.03.010

analysts have greater incentives to cover firms whose values are less well-captured by accounting amounts. As results show, elements of unrecorded intangible assets have informational value to analysts, who follow firms with superior R&D expenditure, and to investors, who find them value relevant. The paper is organized as follows. Section 2 reviews the relevant literature and develops the hypotheses. Section 3 specifies the estimation models and defines the variables used to test the models. Section 4 describes the sample firms. Section 5 presents the results of analysis. Section 6 provides a discussion of results and concludes the study.

2. Background and motivation

2.1. Accounting for intangibles under Egyptian accounting standards

The economic reforms implemented in Egypt in the mid-1990s included a set of mandatory Egyptian accounting standards (EAS) that are based on international accounting standards (IAS). The first set was passed in 1997, followed by two major revisions in 2002 and 2006,[1] all of which closely correspond to IAS (see Elbannan (2011) for elaboration). Notwithstanding these standards, the World Bank (2002) warns against the mediocre state of Egyptian preparers' compliance with EAS. Major causes of non-compliance include the vague legal provisions concerning civil or criminal liabilities of negligent or fraudulent accounting and auditing parties, improper training of accountants and auditors, inadequate regulatory enforcement mechanisms, and unavailability of implementation guidance in the Arabic native language. Weak enforcement mechanisms in place adversely affect the usefulness of reported financial information. To that end, prior research finds that the passage of initial or revised EAS versions did not have a positive effect on the quality of reported financial information (Elbannan, 2011).

Accounting for intangible assets is currently governed by EAS 23 (Ministry of Economy, 2002)[2]/IAS 38 (IASC, 1998), which prescribes the conditions, and timing, for capitalizing intangible assets. Under EAS 23/IAS 38, an intangible asset may be recorded if it was separately acquired, acquired as part of a business combination, or internally developed, after passing certain restrictive criteria. The criteria are intended to improve the reliability of reported intangibles due to concerns that their future economic benefits may be too uncertain, and hence practically requires these expenditures to be expensed when incurred.

2.2. Economic consequences of accounting for intangibles

Extant research uniformly suggests positive effects of R&D expenditures in the form of subsequent gains in productivity, earnings, and shareholder value (Ballester, Garcia-Ayuso, & Livnat, 2003; Barth et al., 2001; Brown & Kimbrough, 2011; Lev & Sougiannis, 1996, 1999, Oswald & Zarowin, 2007). The current accounting treatment of intangibles avoids the capitalization of prominent income-generating and capital accumulation activities, such as software development and employee training costs. Prior research suggests that expensing reduces decision-usefulness of earnings figures and increases the association between current year returns and future earnings (Healy & Wahlen, 1999; Lev & Zarowin, 1999; Oswald & Zarowin, 2007). Siegel and Borgia (2007) argue that the omissions of capital accumulation distort measures of productivity and earnings and reduce predictive value, while capitalization provides clearer signals to investors regarding firm resources and economic performance. Lev and Sougiannis (1999) find that low book-to-market firms have larger R&D expenditure compared to high book-to-market firms, and that R&D expenditure is significantly associated with subsequent returns. Anagnostopoulou (2010) finds that capitalization reduces analyst forecast error. Prior research finds that expensing firms forgo the positive economic effects of capitalization. Wyatt (2005) suggests that limiting managements' choices to record intangible assets tends to reduce, rather than improve, the quality of the balance sheet and investors' information set. Amir and Lev (1996) state that IT-related intangibles generate enormous increasing productivity gains, but that expensing these investments results in distortion to earnings. Aboody and Lev (1998) find that software firms that expense all software costs have positive abnormal return drifts for at least three years after expensing compared to capitalization firms.

To the reporting firms in emerging markets, institutional imperfections add to the negative implications of expensing. Morck, Yeung, and Yu (2000) find that firm-specific information is prevented from being impounded into stock prices in emerging markets due to weak property rights that discourage informed trading. Chang et al. (2000) and Chan and Hameed (2006) examine analyst activity in their cross-country studies, including in a number of emerging markets, and find that country-specific variables influence the extent of analyst activity and the accuracy of analysts' forecasts, and that analysts cover firms with lesser firm-specific (versus market-level) information.

2.3. Analyst coverage and intangibles

Financial analysts collect complex information and process it into a form that is more easily understandable by less sophisticated investors, and provide information that is not publicly available to market participants through management contacts or otherwise (Barth et al., 2001). Through their access to private information, analysts have the potential to identify mispriced securities and make profitable commission-based recommendations to their clients. This potential is greater for firms with substantial intangible assets, and is derived from the information asymmetry and inherent uncertainty associated with intangible assets. Barth et al. (2001) find that firms with relatively higher intangible assets enjoy greater coverage.

Analyst coverage positively affects the association between stock returns and future earnings (Ayers & Freeman, 2003) and improves the efficiency of income smoothing in communicating private information to investors (Sun, 2011). Market participants find analyst information to be superior (inferior) to information obtained from financial reports in high (low) levels of intangible intensity (Amir, Lev, & Sougiannis, 2003). Analysts are selective in their coverage targets, focusing on firms about which they have optimistic views (McNichols & O'Brien, 1997). Coverage is positively related to firm size, growth, stock trading volume, level of voluntary disclosures, larger R&D and advertising expenses, and whether the firm accesses public debt and equity markets, and negatively related to the size of the firm's analysts' brokerage houses (Barth, Clement, Foster, & Kasznik, 1998; Bhushan, 1989; Healy & Wahlen, 1999; Lang & Lundholm, 1993, 1996). Firms that are covered by more analysts have more informative stock (Hong, Lim, & Stein, 2000) and their stock prices incorporate accruals and cash flow information more rapidly (Barth & Hutton, 2004; Lobo, Song, & Stanford, 2012).

To date, country-specific evidence on the effects of accounting information on analyst coverage in emerging economies is scant. In contrast to developed markets, the public dissemination of reliable information in emerging markets is restricted, primarily because of earnings management practices and compliance issues (Aly, Mehdian, & Perry, 2004). Egyptian stock exchanges are credible

[1] The effective date of the most recent (2006) EAS version is January 1, 2007 (Ministry of Investment, 2006).

[2] EAS 23, *Intangible Assets*, supersedes EAS 6, *Research and Development Costs* (came to effect on October 12, 1997). EAS 6 corresponds to IAS 9, *Accounting for Research and Development Activities* (effective date January 21, 1980), which was superseded by IAS 38, *Intangible Assets* (came to effect on July 1, 1995).

Please cite this article as: Elbannan, M.A., Do analysts follow emerging economy firms with higher intangible assets? Empirical evidence from Egypt, *Advances in Accounting, incorporating Advances in International Accounting* (2013), http://dx.doi.org/10.1016/j.adiac.2013.03.010