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Examination of real and accrual earnings management: A cross-country analysis of legal origin under IFRS

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ABSTRACT

This study examines the impact of legal origin differences on accrual and real earnings management behaviors for 14 international financial reporting standards (IFRS) countries. Specifically, a cross-country analysis determines the effects of enforcement intensity and IFRS adoption on earnings management (EM) types, depending on code or common law origins. The results indicate that legal origin directly affects EM behaviors, whereas enforcement intensity and IFRS result in different accrual earnings management (AEM) and real earnings management (REM) behaviors depending on the different legal origins. In particular, the findings also suggest that an increase in enforcement strength may not produce similar EM results for each legal tradition, specifically for the expected shift from AEM to REM as recent studies have proposed. This study also offers evidence that IFRS represent a constraint on AEM in code law origin countries, and it highlights a constraint on REM only for common law countries when the enforcement intensity increases.

1. Introduction

International financial reporting standards (IFRS) are the most common financial reporting language enhancing the worldwide harmonization of accounting standards for more than one hundred and forty countries. Although IFRS adoption is incremental in an international context, the courses of adoption for many adopting countries differ primarily for the legal origin depending on whether the adopting country is a '*common*' or a '*code*' law country. Differences in legal tradition(origin) might lead to the deterioration of financial information quality due to diverse accounting and reporting practices. Therefore, present study attempts to examine the expected discrepancies for the financial information quality through scrutinizing earnings management (EM) for IFRS countries under different legal origins.

The EM process for the two legal origins is scrutinized for accrual earnings management (AEM) and real earnings management (REM) due to the distinctions of the two legal traditions for financial reporting, accounting quality, and managerial behavior for earnings (Kothari, 2000). Specifically, in line with the previous research, to measure a shift in EM from AEM to REM, the study examines the effects of enforcement intensity (Evans, Houston, Peters, & Pratt, 2015) and IFRS (Ho, Liao, & Taylor, 2015) as the two financial quality measures.

The legal origin of a country may affect the principles of institutions and accounting practices that relate to the quality of financial information. IFRS are a set of common law-oriented high-quality accounting standards (Ball, 2006) in which institutional and accounting practices rely more on market activities and financial disclosure than code law legal system does (Ball, Kothari, & Robin, 2000). However, recent trends indicate that the code law countries are the dominant IFRS adopters and have institutional settings and preferences that differ from those of common law countries. Common law institutional practices favor public disclosure, which increases the quality of financial information; code law institutional practices foster communication between managers and stakeholders (Ball, Kothari, et al., 2000). The dissimilarities between these two legal origins may remain in practice, and changes in accounting applications may require additional time for post-IFRS adoption (Barth, Landsman, Lang, & Williams, 2012; Soderstrom & Sun, 2007). On the other hand, differences in IFRS applications might occur because of a lack of IFRS knowledge and because of opportunistic managerial behaviors (Ball, Robin, & Shuang Wu, 2003). In other words, "***IFRS adoption does not necessarily mean IFRS-type accounting practices,***" as indicated by Chen and Zhang (2010). In addition, the code law institutional settings associated with the political influence of stakeholder groups on accounting applications (Ball, Robin, & Shuang Wu, 2000) might encourage opportunistic accounting behavior through managerial discretionary expenses (Ball, Kothari, et al., 2000). Therefore, this study scrutinizes: i) discretionary expenses under code and common law legal origins to examine whether

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managers, employing REM, manipulate earnings through operating activities, in line with Roychowdhury (2006), and ii) the differences between AEM and REM behaviors under IFRS for different legal systems.

Aside from differences in legal origins, the enforcement mechanism is vital to improving the quality of financial information. The enforcement mechanism focuses on compliance with rules and regulations regarding external audits, judicial efficiency, law and order traditions, and insider trading (Hope, 2003). IFRS are a set of quality accounting standards; however, improper enforcement causes financial reporting processes to deteriorate due to inconsistent implementation of regulatory rules. Prior studies have indicated that IFRS adoption results in higher quality accounting information in strong enforcement countries (Barth, Landsman, & Lang, 2008; Barth et al., 2012; Landsman, Maydew, & Thorncock, 2012). IFRS alone, however, may not decrease AEM (Jeanjean & Stolowy, 2008; Van Tendeloo & Vanstraelen, 2005) and REM (Doukakis, 2014). Therefore, this study assesses the significance of enforcement intensity and examines differences in REM and AEM with respect to enforcement levels in common and code law countries under the unified accounting standards.

This study also expects to contribute to extant literature by investigating the shift in EM behavior from AEM to REM in an international cross-country context. A recent study by Evans et al. (2015) indicates that EM has shifted from AEM to REM only in US GAAP firms domiciled in the US due to a strong regulatory environment that restricts EM through accruals and substitutes AEM for REM. In addition, the shift to REM is detected only in strong enforcement common law countries (Francis, Hasan, & Li, 2016). Although code law countries are well known for their weakly enforced economic environments (Christensen, Hail, & Leuz, 2013), their institutional and financial reporting traditions, which rely more heavily on insider communication and less on public disclosure (Ball, Robin, et al., 2000), may also foster shifts from AEM to REM. Code law accounting practices rely on managerial discretion specifically for discretionary expenses (Ball, Kothari, et al., 2000), which is the primary component of REM. Furthermore, IFRS adoption may even enhance the opportunity for REM because IFRS require managerial judgment in the accounting process due to its nature (Ahmed, Neel, & Wang, 2013). Therefore, this study expects to detect REM also in code law countries different than the previous studies. The study examines AEM and REM behaviors in regard to legal origins while controlling for enforcement intensity and accounting standards on a cross-country basis.

To address the arguments discussed above, present study contributes to the literature and scrutinizes EM behavior as follows: In the first stage, the impact of differences in legal origin, enforcement intensity, and IFRS on AEM and REM is examined, with the expectation of finding a significant effect related to the cross-country context. In the second stage, the sample countries are partitioned by legal origin, in accordance with their enforcement strengths, to allow for analysis of EM behaviors. During this stage, the combined effects of the enforcement level & IFRS on AEM and REM are examined as complementarity between these two types of earnings management practices has been suggested in prior studies (Kothari, 2000). In the third stage, study investigates whether AEM has shifted to REM owing to enforcement intensity and the implementation of IFRS. This stage examines the subsamples established based on legal origins. The study explores two issues to verify a shift from AEM to REM: i) whether there has been a substitution effect between AEM and REM and ii) whether AEM decreased while REM increased to a statistically significant degree. To the best knowledge of the researchers, this is the first study to explore a shift of REM with regard to these two issues. In addition, the study determines the combined effects of enforcement level & IFRS and legal origin & IFRS on AEM and REM. The final stage establishes German code and French code samples by partitioning the code law sample and assesses the implications for EM behavior by comparing Common, German and French code samples.

2. Background and hypothesis development

Legal origin is an important factor in the quality of accounting information of firms that operate within a country (Ball, Kothari, et al., 2000; Kothari, 2000). La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) and La Porta, Lopez-de-Silanes, and Shleifer (2006) highlight the differences among legal origins from Scandinavian to Common and Common to Code and conclude that the legal system is significantly related to the quality of accounting information. Ball, Kothari, et al. (2000) focus on the accounting traditions of legal origins and indicate that the common law system is more conservative because loss recognition under that system is timelier than under code law system. In addition, the results indicate that political and institutional influence leads to a deterioration of financial disclosure, impacting the quality of accounting information. Unlike the common law tradition, Kothari (2000) asserts that the code law tradition is stakeholder-oriented; information provided in financial statements is primarily used by governments, banks and other institutions. The stakeholder focus of code law reduces the need for public disclosure because the aforementioned institutions are the primary financiers of economic participants and have easy access to financial information through insider communications. Ashiq and Hwang (2000) remark that the value relevance of accounting information in common law countries is greater than that in code law countries. Prior studies have reported that accounting practices and information quality may change, depending on the legal origin. In addition, prior studies have examined the value relevance, timeliness and disclosure practices of financial information for different legal traditions. The early studies primarily focus on EM through accruals (Burgstahler & Dichev, 1997; Dechow, 1994; Healy, 1985; Healy & Wahlen, 1999; Jones, 1991; Subramanyam, 1996). However, EM has been examined not only through accruals but also through operating activities (Roychowdhury, 2006). Cohen, Dey, and Lys (2008) indicate that the dominant practice of accruals-based earnings management preceded the Sarbanes Oxley (SOX) Act of 2002. However, during the following years, the study finds a shift toward real activities earnings management due to heightened accounting regulations in general. Similarly, Evans et al. (2015) emphasize that strong enforcement caused a shift to REM from AEM among US GAAP firms domiciled in the US. Zang (2012) examines factors that influence the tradeoff between REM and AEM in managerial decision making, identifying two earnings management approaches practiced by managers as substitutes and assessing their relevant costs. The scrutinized regulatory environment, limited accounting flexibility and shorter operating cycles were motives for practicing REM, but weak financial conditions, intense institutional investor monitoring, and high levels of tax expenses enabled the use of AEM. Prior studies highlight the need to examine EM, specifically REM, in common law countries because of the strong enforcement environment. Nevertheless, institutional behaviors, including the sharing of financial information, not relying on public disclosure, allowing managerial discretion, and managing earnings through discretionary expenses, in the code law tradition are already components of REM, as indicated by Ball, Kothari, et al. (2000). Therefore, this study notes the importance of examining the impact of legal origin on EM behaviors. The first hypothesis is as follows:

H1. Legal Origin affects REM and AEM behaviors.

Enforcement strength has also been found to be a significant variable for EM; the present study therefore examines its impact on EM under different legal systems. Burgstahler, Hail, and Leuz (2006) examine EM through accruals of public and private firms due to weak enforcement in certain European countries operating under the same accounting regime. Contrary to expectations, strong enforcement cannot diminish total EM by increasing REM. Leuz, Nanda, and Wysocki (2003) indicate that strong enforcement is a decreasing factor in AEM. However, the use of real activities earnings management demonstrates that managers can continue to manage earnings despite a detailed focus