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Earnings Management and Institutional Differences: Literature Review and Discussion

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I. INTRODUCTION

This paper provides (1) a review of the empirical earnings management literature, (2) a discussion of the institutional differences between Anglo-Saxon and non Anglo-Saxon countries and (3) an assessment of the impact of institutional differences on earnings management.

As (accounting) earnings can be considered an important summary statistic of a firm's financial performance, one can question whether managers do not "manage" those earnings. It is clear that financial, investment and operational decisions can influence earnings. However, accounting decisions too can be used to manage earnings in a particular direction, for GAAP leave some discretion to managers in reporting the financial position and operating results of their organization. Examples of accounting decisions that can influence earnings are accrual decisions, accounting procedure choices and changes, timing of adoption of a mandated accounting change, and the like.

Earnings management has been researched in the literature both analytically and empirically. Analytical models (see, for example, Lambert (1984), Demksi et al. (1984), Verrecchia (1986), Dye (1988), Trueman and Titman (1988), Fudenberg end Tirole (1995), Evans and Sridhar (1996)) study conditions under which earnings management

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can occur, whereas empirical studies document instances of earnings management (Schipper (1989)). In this paper, we limit ourselves to a review of the empirical earnings management literature.

The review provides some evidence that managers have incentives to manage earnings, that they do actually engage in earnings management and that there are factors that constrain their ability to manage earnings. Some studies report also on the consequences of actual or assumed earnings management. Most empirical studies were performed in Anglo-Saxon countries. Since there exist institutional differences between Anglo-Saxon and non Anglo-Saxon countries, we argue that the factors that create incentives for and constraints on earnings management may be different for these environments, and some results of Anglo-Saxon studies may not hold in non Anglo- Saxon countries.

The remainder of the paper is organized as follows. The second section presents a literature review. The third section discusses the institutional differences between Anglo-Saxon and non Anglo-Saxon countries. An assessment of their viable impact on factors that create incentives and constraints on earnings management is provided in section four. We conclude with a summary.

II. LITERATURE REVIEW

Empirical studies mainly report on the incentives to manage earnings. Some recent empirical studies also examine factors that might constrain earnings management. The following paragraphs give an overview of (1) the incentives to manage earnings, (2) the factors that might constrain and (3) the consequences of earnings management.

A. *Incentives*

Incentives to manage earnings may stem from the existence of explicit and implicit contracts, a firm's relations with capital markets, the need for external financing, the political and regulatory process or several specific circumstances. A firm may also be induced to engage in a specific type of earnings management, i.e. income smoothing.

1. Explicit and implicit contracts

A first category of incentives examined stems from the contracting literature. In the early literature it is often argued that earnings management is induced by the existence of *explicit* contracts, for example bonus plans and debt covenants. The recent literature, however, also focuses on *implicit* contracts, as a source of earnings management incentives. The main concern that "drives" these studies, is that, although the flexibility provided by GAAP can improve efficient contracting, managers might use this flexibility to act opportunistically.

A first well established hypothesis in the empirical financial accounting literature is that *bonus plans* based on accounting earnings might induce managers to manage (manipulate) earnings through their accounting procedure and accrual decisions, in order to increase their cash compensation. More specifically, early studies test the *bonus plan hypothesis*, which states that "Ceteris paribus, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period" (Watts and Zimmerman (1986), p.208). Later studies examined related and more refined hypotheses using different measures of earnings management and using other datasets. Examples of studies on the bonus plan hypothesis include Healy (1985), McNichols and Wilson (1988), Gaver et al. (1995), Holthausen et al. (1995) and Dechow et al. (1996). Although the early literature finds evidence that is generally consistent with the bonus plan hypothesis (Watts and Zimmerman (1990), p.138), more recent studies document mixed results (that is, results differ when other datasets and measures of earning management are used). This comes as no surprise, as Watts and Zimmerman ((1990), p.139) argue that the early tests are not very powerful, because they rely on simplifications of the (contracting) theory.

Another well established hypothesis in the contracting literature is that the (1) existence of and/or (2) closeness to *debt covenants* might induce managers to manipulate accounting earnings. Early empirical studies that test *the covenant based hypothesis* use leverage as a proxy for (1) the existence of and/ or (2) closeness to debt covenants. In fact, they test what is called *the debt/equity hypothesis*. More specifically, it is hypothesized that "Ceteris paribus, the larger a firm's debt/equity ratio, the more likely the firm's manager is to select accounting procedures that shift reported earnings from future periods to the current period." (Watts and Zimmerman (1986), p.216). Later studies provide "direct" evidence of the covenant based hypothesis. DeFond and Jiambalvo (1994) and Sweeney (1994), for example, contribute to the literature because they do not use a proxy, but base their study of the covenant based hypothesis on a sample of firms that actually reported to have violated debt covenants. Other studies include: Dechow et al. (1996) and DeAngelo (1994). Except for the DeAngelo (1994) study, both the early accounting choice studies, which use proxies, and more recent research, which circumvents the use of such proxies, document (in general) evidence consistent with the covenant based hypothesis.

The above evidence suggests that *explicit* contracts have an impact on earnings management through accounting decisions. Bowen et al. (1995) and Kasanen et al. (1996) examine whether *implicit* contracts (that is, for example, implicit contracts between the firm and its customers, suppliers, short-term creditors, employees, capital providers and other stakeholders) do also influence managers' accounting decisions. Both studies find evidence which is consistent with implicit contracts inducing earnings management. Moreover, Bowen et al. (1995) find that implicit contracts can explain cross-sectional variance in firms' accounting procedure choices *in addition* to traditional variables, for example, the proxies for the explicit contracts mentioned above, that is bonus plans and debt covenants. However, the literature on implicit contracting incentives is rather new and limited, and so it seems too early to draw general conclusions.

2. Capital markets and need for external financing

The *contracting perspective* is not the only way to look at management's accounting decisions. An alternative is to address those decisions from a *capital market perspective* (see, for example, Healy and Palepu (1993)). In general, research findings provide empirical evidence that a firm's relation with capital markets can create incentives to influence earnings. Some of those studies expect firms to manage earnings opportunistically (Shivakumar (1998), Dechow et al. (1996), Rangan (1998) and Teoh et al. (1998)). Other studies consider that earnings may be managed in order to communicate private information to investors (Subramanyam (1996), Neill et al. (1995)). Subramanyam (1996), for example, finds supportive evidence of the hypothesis that managers use discretionary accruals to communicate information about future profitability, that is the economic value of the firm. Also the findings of Neill et al. (1995) suggest that accounting method choice can signal firm value. Dechow et al. (1996) test whether managers manipulate earnings to influence investor's perception of firm value in order to be able (1) to raise additional financing on more favorable terms or (2) to sell their stockholdings for a higher price. They find that the need for external financing seems to be an important motive to explain managers engaging in earnings manipulation, whereas insider trading seems to be less important. Some recent studies find that earnings are managed prior to or around initial public offerings (Friedlan (1994), Aharony et al. (1993), Neill et al. (1995)) or seasoned equity offerings (Shivakumar (1998), Rangan (1998), Teoh et al. (1998)).

3. Political and regulatory process

The political and regulatory process through, for example, taxes, rate regulation and investigations by regulatory agencies may also create incentives to manage earnings (see, for example, Watts and Zimmerman (1986)). A hypothesis often tested in accounting choice studies is the *political cost hypothesis/ size hypothesis*, which states that "Ceteris paribus, the larger the firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods" (Watts and Zimmerman (1986), p.235). Note that formulating the hypothesized impact of the political and regulatory process this way, assumes that larger firms are more political sensitive than smaller firms. Recent research on the impact of the political and regulatory process on earnings management includes Jones (1991), Guenther (1994), Bowen et al. (1995), Hunt et al. (1996), Key (1997) and Han and Wang (1998). In general, one can conclude that prior research provides evidence consistent with earnings management induced by the political or regulatory processes.

4. Specific circumstances

There exist also some studies that examine whether specific circumstances induce earnings management. Liberty and Zimmerman (1986), for example, study the impact of labor union contract negotiations on managers' accounting decisions, but do, however, not find evidence of earnings management. And DeAngelo (1988) examined whether proxy contests create incentives for managers to influence earnings and finds evidence consistent with this hypothesis. In particular, it seems that, during the election campaign, managers use their accounting discretion to create a favorable picture of their performance.

Finally, a recent study (Burgstahler and Dichev (1997)) finds evidence consistent with the hypothesis that earnings are managed to avoid earnings decreases and losses.

5. Income smoothing

Some studies examine a specific type of earnings management, i.e. income smoothing. The hypothesis is that managers might manage earnings to reduce the variability of reported earnings or to align reported earnings with expected earnings. Explanations for income smoothing include job protection and avoidance of shareholder interference, tax avoidance, improving terms of trade and pursuing a fixed dividend pay-out ratio. Studies include Eckel (1981), McNichols and Wilson (1988), Hunt et al. (1996), Subramanyam (1996), DeFond and Park (1997), Young (1998). The evidence on the income smoothing hypothesis is however mixed.

B. *Constraints*

From the above review it is clear that until now empirical research has mainly focused on the *incentives* to manage earnings. Recent research also examines *factors that might constrain* earnings management. These include prior accounting decisions, ownership structure, strength of the internal controls, internal governance (especially the existence of an audit committee and some characteristics of the board of directors, such as, for example, board size, board composition and separation of the functions of Chairman of the Board of Directors and Chief Executive Officer) and quality of the external audit.

The impact of prior accounting decisions on earnings management was studied by DeFond and Jiambalvo (1991). They found that earnings "manipulation" is more likely in firms where the remaining number of income-increasing GAAP possibilities is smaller. Moreover, Sweeney (1994), argues that the accounting flexibility available to managers, which is influenced by their prior accounting decisions, is an important determinant of managers' accounting responses to debt covenant violation.

The impact of ownership structure on earnings management was examined by DeFond and Jiambalvo (1991), Warfield et al. (1995) and Rajgopal and Venkatachalam (1998). Research results suggest a negative relation between (1) managerial ownership (Warfield et al. (1995)) or institutional ownership (Rajgopal and Venkatachalam (1998)) and (2) the magnitude of accounting accrual adjustments (=a measure for the extent of earnings management). Earnings "manipulation" was, however, found more likely in firms with diffuse ownership (DeFond and Jiambalvo (1991)).

Further, results indicate that earnings overstatements are less likely in firms that have an audit committee (DeFond and Jiambalvo (1991)). However, no evidence was found that stronger internal controls reduce the likelihood of earnings overstatement (DeFond and Jiambalvo (1991)).

Studies on the impact of the characteristics of the board of directors on earnings management (Dechow et al. (1996), Peasnell et al. (1998) and Beasley et al. (1996)) find that at least some of those characteristics are related to earnings management.

Further, several studies examine whether a higher quality audit constrains (opportunistic) earnings management more than a lower quality audit. The impact of audit quality on both GAAP as well as non-GAAP earnings management was tested. Evidence was found of a relation between audit quality and earnings management within GAAP. In particular, Becker et al. (1998) found that discretionary accruals for clients of non-big6 auditors are higher than for clients of big6 auditors. Francis et al. (1997) found that the amounts of discretionary accruals of big6 client firms are lower than those of non-big6 client firms. The evidence on the relation between audit quality and non-GAAP earnings management is, however, mixed. Dechow et al. (1996), do not find that the use of a Big6 auditor differs between firms that were subject to enforcement actions by the SEC (that is, firms that are "suspected" to have engaged in non-GAAP earnings management) and the control firms. Higher audit quality was, however, found to reduce the likelihood of errors and irregularities (DeFond and Jiambalvo (1991)) and to increase the likelihood of auditor-client disagreements over income-increasing accounting methods (DeFond and Jiambalvo (1993)). Finally, Shivakumar (1998) finds some evidence which, he argues, is consistent with auditors limiting managerial discretion over accounting procedures.

C. *Consequences*

Some studies do not only examine the factors that *induce* or *constrain* earnings management, but study also the *consequences* of actual or assumed earnings management. This research is, at the moment, limited to the consequences of earnings management induced by a firm's relation with capital markets. In particular studies examine whether firms (or firm managers) succeed in their attempt to influence their relations with a specific stakeholder, i.e. investors. They provide also some evidence on the long run consequences of earnings management.

Several studies examine the stock price effect of changes in accounting procedures. Early studies try to discriminate between two competing hypotheses, i.e. the mechanistic (functional fixation) hypothesis and no-effects hypothesis (see Watts and Zimmerman (1986)). The first hypothesis is based on the assumption that investors are functionally fixated, i.e. interpret the earnings number the same way regardless of the accounting procedures used to calculate them (Watts and Zimmerman (1986), p.160). This implies that investors can be fooled and that stock prices will react to announcements of changes in accounting procedures, even when those changes have no cash flow effects. The no-effects hypothesis, a joint hypothesis of the efficient market hypothesis, the CAPM and the assumptions of zero information, contracting and transactions costs, by contrast claims that the market can see through the effects of accounting changes. Consequently, stock prices should only react to announcements of changes in accounting procedures when there are cash flow effects. Studies include those on voluntary changes in inventory procedures (LIFO vs. FIFO) by for example Sunder (1973 and 1975), Ricks (1982), Biddle and Lindahl (1982). Those studies however failed to discriminate between the two competing hypotheses (see Watts and Zimmerman (1986)).

The early studies assumed that tax was the only possible cash flow effect. Later studies dropped some assumptions of the no-effects hypothesis, i.e. the assumptions of zero information and contracting costs. Consequently, changes in accounting procedures could have cash flow effects, other than taxes. In particular, those changes could influence contracting and political costs. This implies that accounting changes without tax effects could have stock price effects, even when investors are not functionally fixated. Those studies did however not try to discriminate between the functional fixation and no-effects hypotheses. They rather wanted to explain accounting procedures (Watts and Zimmerman (1986), p.110). For an overview of studies, see Watts and Zimmerman ((1986), chapter 12).

Except for the study of Neill et al. (1995), recent studies focus on the implications of possible accruals management around an IPO or seasoned equity offering. Shivakumar (1998), for example, finds that, when firms manage earnings prior to an equity offering, investors already recognize this at the equity offering announcement date, which suggests that investors cannot be "fooled" by managing earnings. He finds also a decrease in the stock price response to subsequent earnings announcements, which he attributes to earnings management. The evidence of Dechow et al. (1996) suggests however that firms managing earnings do initially succeed in their attempt to influence investors' perception of firm value. They also report that their evidence suggests that, when earnings management is revealed, increases in the costs of capital follow. Rangan (1998) and Teoh et al. (1998) find that the poor (stock and income) performance of seasoned equity offerings in the post-offering announcement period, can be explained by earnings management around or prior to the equity offering. Neill et al. (1995) find that both offering values and underpricing are related to accounting method choice. He suggests that this is not the result of opportunistic earnings management, but of accounting method choice being a credible signal to investors of firm value.

Results as to whether investors are fooled in the short term are thus mixed. In the long run, however, the market seems to see through earnings management.

III. INSTITUTIONAL DIFFERENCES BETWEEN ANGLO-SAXON AND NON ANGLO-SAXON COUNTRIES

From our review of the literature (Flower (1997), Ball et al. (1997), Nobes and Parker (1995), Alexander and Nobes (1994), Joos and Lang (1994), FEE (1997), Paisey (1991) and Nobes (1984)) it is clear that there exist institutional differences between countries along various dimensions. Those are, for example, differences in legal systems, in providers of finance (in particular, the importance of capital markets), in ownership and corporate governance and in the link between tax and accounting (see, for example, Nobes (1984)). Such factors may cause the various international differences that can be observed in accounting (Nobes (1984), p.3). Differences at the accounting level are, for example, a different source of demand for accounting (that is, different goals for financial reporting and different key users of financial statements), different conceptual frameworks (FEE (1997)) and accounting systems, different sources of accounting rules and degree of detail in which they are specified. It seems a logical consequence that those differences will, in turn, have an impact on the ability and the incentives to manage earnings.

In the literature on institutional and accounting differences between countries one often classifies countries as either 'Anglo-Saxon' or 'continental European'. The US and the UK are typical examples of Anglo-Saxon countries, whereas Germany, France and Belgium are typical examples of continental European countries. Some countries on the European continent have however characteristics which are closer to these of (typical) Anglo-Saxon countries. In the Netherlands, Sweden and Switzerland, for example, the importance of capital markets as providers of finance is very substantial, as is the case in Anglo-Saxon countries. To avoid a geographical association of countries with a certain category, and because countries are similar or different with respect to some institutional characteristic but perhaps not another, we believe that a dichotomous classification of Anglo-Saxon versus continental European countries is not appropriate. Further, recent developments in corporate financing and accounting have made the (traditional) institutional differences between Anglo-Saxon and continental European countries less pronounced, although important differences still remain. Therefore we first provide a discussion of various institutional dimensions along which countries can differ in subsection III.1. and then continue with a discussion of recent developments in subsection III.2..

A. *Institutional and accounting characteristics of countries*

1. Differences in legal systems, financing and ownership

a. Common law *versus* codified law systems

A country's legal system can be characterized by a common law system or a codified law system. Anglo-Saxon countries typically operate under common law systems. In such a system there is only a limited amount of statute law as only general principles are enacted by the legislator (Flower (1997), pp.38-39). The courts then interpret those principles and build up a body of case law. Most non Anglo-Saxon countries operate under codified law systems, which are based on Roman law and where rules are specified in great detail. The main role of courts in those systems is to enforce the law.

b. Large stock market capitalization with widespread ownership *versus* limited stock market capitalization with concentrated ownership

The major differences in ownership and providers of finance between countries can be summarized as follows. Typical Anglo-Saxon countries have well developed capital markets. Companies which are important players in the economy are listed on the stock exchange (see also Note 1) and in these companies, shares are held by a vast number of individual shareholders (widespread ownership). In non Anglo-Saxon countries, however, capital markets are typically less developed, although there is a current trend towards increasing stock market capitalization (see subsection III.2). Only a minority of companies is listed on the stock exchange. Funds are mainly provided by, for example, banks (this is the case, for example, in Germany) and other financial institutions, the state (for example, in France), family members or business contacts. Ownership is concentrated (that is, there are few shareholders) in both listed and non-listed firms.

Some figures may illustrate the differences. Stock market capitalization as a percentage of GNP in 1995 was: 123% in the UK, 82 % in the US but only 38% in Belgium, 33% in France and 24% in Germany. The stock market capitalization in the Netherlands (74%), Sweden (77%) and Switzerland (131%) is however of comparable size as in the US and UK (Daems (1998), p.33).

2. Accounting differences

a. Origin of demand for financial statements: shareholders *versus* government

The above differences in legal systems, providers of finance and firms' ownership structure have several implications on the accounting level. In particular, the differences in ownership structures have an impact on the demand for accounting information and the users of financial statements. The fact that in Anglo-Saxon countries funds are obtained from a vast number of individual shareholders raised through the capital market makes the financial statements an important means to communicate information to shareholders. Hence shareholders are the main users of published financial statements. Companies are also willing to provide this information to enhance their ability to raise additional funds through the capital market. By contrast, in non Anglo-Saxon countries, where ownership is (even in listed firms) typically concentrated, the major providers of finance obtain information through direct contacts and internal financial reports. In Germany, for example, bankers have often a seat on the board of directors. In non Anglo-Saxon countries demand for financial information originated mainly from government, who needed this information in order to plan and control the economy or to raise taxes. As companies had little incentive to make accounting information public, governments made publication of financial statements mandatory (Flower (1997), p.41)[1].

b. Provision of information to capital markets *versus* prudent assessment of distributable profit and/or tax assessment

Differences in ownership structure and related differences in major users of financial statements parallel the traditional differences in the (traditional) purpose of financial reporting. In the UK and US, the important players in the economy are listed companies. The dominant objective of financial statements in those countries is then also to provide information to capital markets. In non Anglo-Saxon countries where third party protection (for example, creditor protection) is paramount and demand for financial statements stemmed mainly from the government, both prudent assessment of distributable profit (to protect third parties) and tax assessment (for government) have traditionally been important objectives of financial reporting. Tax and financial reporting is closely linked, whereas in the US by contrast companies have to file separate financial statements for tax purposes.

c. Substance over form and matching *versus* prudence and historical costs

Differences in objectives of financial reporting resulted in different accounting frameworks, that is, "the fundamental concepts which lie behind the accounting law or regulation" (FEE (1997), p.3). The FEE ((1997), p.8) reports that, in Anglo-Saxon countries the most important principles seem to be the substance over form and the matching principles. In countries where creditor protection is considered a particular important objective of financial reporting (like, for example, in Germany), special attention is given to a conservative application of the prudence and historical cost principles. In those countries where tax assessment seems to be an important objective of financial reporting, it is difficult to identify any dominant concepts.

d. Profession based accountancy *versus* law based accountancy

Finally, differences in legal systems as well as different users of financial statements are related to different sources of accounting rules and the degree of detail in which they are specified. Nobes ((1984), p.16) reports that in code-law countries accounting rules are mainly to be found in company laws, commercial codes and tax regulations. This means that accounting rules are law-based (law-based accountancy). These codes usually also specify detailed rules for accounting and financial reporting. In common-law countries, however, it is the accounting profession itself which effectively governed accounting practice, which resulted in detailed accounting standards (profession-based accountancy). Company law did not prescribe detailed rules on how companies should publish their financial statements[2].

B. *Recent institutional developments and their (viable) impact on accounting practice*

A fairly recent important evolution in several continental European countries is the trend towards a more Anglo-Saxon way of corporate financing and accounting. Two factors have been and still are important in this context: (1) accounting harmonization and (2) increased risk financing in continental Europe.

Since the seventies, EC harmonization programs have attempted to reduce differences between national accounting systems in EC countries (see for example the Fourth and Seventh Directive which deal with the annual accounts of individual companies and consolidated accounts, respectively). Although these directives have been implemented across member states of the European Union, many differences remained. In the UK, for example, where accounting was traditionally profession-based, several accounting rules were introduced into the law (see, for example, Alexander and Nobes (1994), p.84) but this didn't change the key characteristics of the British accounting system. While the Fourth Directive provided for example the possibility to separate tax and financial accounting, the traditional link between them still seems to exist in several non Anglo-Saxon countries (FEE (1997)). Also, while the true and fair view principle, which is typical Anglo-Saxon (UK) was adopted in the fourth directive, its practical impact remains limited in non Anglo-Saxon countries, as it is often interpreted as complying with the rules in these countires (FEE (1997), p.8).

The efforts of the International Accounting Standards Committee (IASC) to harmonize accounting and financial reporting across countries (IASC core standards project)[3] introduce (some) Anglo-Saxon thinking outside the Anglo-Saxon world. This harmonization attempt is principally fuelled by the globalization of capital markets and is encouraged and supported by the International Organization of Securities Commissions (IOSCO) and the (US) Securities and Exchange Commission (SEC) (see for example Zeff (1999), Cairns (1997)). Many exchanges (the London stock exchange and Easdaq, for example) already accept that foreign companies prepare financial statements according to the International Accounting Standards (IASs) developed by the IASC. Notable exceptions are the New York Stock Exchange and Nasdaq. On those exchanges, foreign companies can file financial statements prepared using IASs, but the SEC still requires that they reconcile earnings and shareholders' equity to US GAAP. According to the European Commission member states can allow companies to use IASs in preparing their consolidated accounts. Whether preparing statements according to US GAAP would fit within European law is not yet clear however (Batt (1998)). To avoid double work, national regulators in some EU countries already allow, intend or consider to allow multinational companies and/or companies that are listed on foreign exchanges to prepare and file their "local" group accounts according to IAS or US GAAP (see for example Batt (1998), Belgrado et al. (1998)). Belgian firms for example which are listed on a foreign exchange or operate internationally are allowed to prepare their Belgian group accounts according to IASs or the foreign principles involved (for example, US GAAP)[4].

Some argue that IASs are dominated by "the Anglo-Saxon approach to financial reporting" (Zeff (1999), p.10)[5]. Also, as the NYSE and Nasdaq do not yet allow financial statements based on IASs, companies may choose to follow US GAAP. Adoption of IASs or US GAAP by non Anglo-Saxon companies definitely introduces Anglo-Saxon accounting thinking in continental Europe. Companies which (may) undergo this impact are (1) multinational parent companies which have to issue group accounts, (2) their foreign subsidiaries which report to them and whose figures have to be consolidated in the parent's accounts, (3) European subsidiaries of American companies, and (4) companies which are quoted on a foreign exchange. However, IASs or US GAAP do not affect all non Anglo-Saxon companies. Companies which do not belong to an international group, and/or which do not have to issue group accounts[6], continue to report according to their national GAAP, when not listed on a foreign exchange. This is still a substantial part of the economy in many continental European countries. Further, any company's (whether or not it operates internationally) individual accounts continue to be based on national GAAP. As yet, there is no uniform accounting practice, although differences between typical Anglo-Saxon and non Anglo-Saxon practice decreases.

There is a second trend which may be expected to lead to a further reduction in institutional and accounting differences. In continental Europe, more firms are looking for risk financing and are finding their way to the exhanges. The increase in IPOs over the last years on several continental European exchanges illustrates this trend. The ownership and financing of such companies is thus changing significantly, and this will also have an accounting impact. As more firms go public, ownership of a larger set of firms will become less concentrated and investors become important users of financial statements. The dominant purpose of financial reporting will shift from creditor protection and/or tax assessment to information provision[7]. Companies will be more willing to provide this accounting information, as (1) they depend to a larger extent on outside investors for the financing of their operations and (2) the competition for outside risk financing increases. As users and purposes of financial reporting change, it is reasonable to expect that accounting frameworks will adapt to fit the context in which the accounts are used. Overall, Anglo-Saxon institutional characteristics are starting to apply in continental European countries.

IV. DISCUSSION OF THE IMPACT OF INSTITUTIONAL DIFFERENCES ON INCENTIVES FOR, OPPORTUNITIES OF AND CONSTRAINTS ON EARNINGS MANAGEMENT

Incentives of and constraints on earnings management are mainly affected by a firm's corporate financing, its ownership structure, and the accounting environment in which it operates. Since there exist differences between Anglo-Saxon and non Anglo-Saxon companies, the incentives and constraints which were investigated in Anglo-Saxon studies (see section II) may not equally apply in continental Europe. However, the trend towards a more Anglo-Saxon way of financing and accounting in continental Europe (as discussed in subsection III.2) again makes a dichotomous assessment of earnings management differences between Anglo-Saxon and non Anglo-Saxon countries impossible. A better assessment, perhaps, would be to discuss differences between companies (irrespective of nationality) which have Anglo-saxon characteristics (for example, widespread ownership, financed by capital markets, adopting US GAAP or IASs, ...) and those which have not.

A. *Institutional differences and incentives for earnings management*

Our views with respect to incentives for earnings management are the following. First, we believe that earnings management induced by explicit contracts, such as management compensation contracts and debt covenants, might be less important for companies characterized by a concentrated ownership structure. With concentrated ownership, which is a typical non Anglo-Saxon characteristic, there are fewer conflict of interest and information asymmetry problems between owners and managers. It is a fact that bonus plans and debt covenants are less prevalent in non Anglo-Saxon countries. In listed continental European firms with concentrated ownership, however, another type of conflict of interest may become important, namely between small and large shareholders.

Differences in systems of corporate governance also help explain the relatively smaller reliance on bonus plans and debt covenants. In fact, in continental European countries, providers of finance (and other stakeholders to the company) are more directly involved in corporate governance, whereas in Anglo-Saxon countries corporate governance relies more on external board members and on monitoring by external providers of debt and equity capital (Ball (1997), p. 8). In Belgium and Germany for example, important providers of finance have often a seat on the board of directors[8].

Second, for non-listed companies, the incentives to manage earnings created by capital markets (in particular, earnings management in order to communicate private information to investors, or earnings management in view of raising new funds on capital markets at more favorable terms) do not apply. Note that this is still the majority of companies in non Anglo-Saxon countries, although there is an increasing trend in risk financing.

Third, we believe that the incentives to manage earnings created by the political and regulatory process are especially important in non Anglo-Saxon firms, given the close relationship between financial reporting (in the individual accounts) and tax reporting. If taxes are assessed based on profit figures reported in individual accounts, the incentive applies to all types of companies (internationally operating or not, listed or not).

Fourth, in contrast to explicit contracts, we expect that implicit contracts are especially important in creating earnings management incentives in firms with concentrated ownership. Concentrated ownership might create implicit contracts between a firm and its major shareholders, who often have a seat on the board of directors. Kasanen et al. (1996), for example, find that (for listed firms) implicit contracts on dividends with institutional shareholders can be important in creating incentives to manage earnings.

Fifth, we expect that income smoothing, a particular type of earnings management, may be important in non Anglo-Saxon countries. Typical explanations for income smoothing in the (Anglo-Saxon) literature are job protection, maximization of compensation and avoidance of shareholder interference. These incentives may however be less important for firms characterized by concentrated ownership and which consequently have a low degree of separation between ownership (shareholders) and control (management). In those companies other incentives are however playing a major role. Tax avoidance and pursuing a fixed dividend pay out ratio (see also above) may induce firms to engage in this particular type of earnings management. The rationale is the close link between tax and financial reporting (individual accounts), the link between the reported earnings figure and dividend payments (see Ball (1997), p. 2), and the potential influence of the (majority) shareholders over those dividend payments. Note that this is especially likely to hold for earnings management in individual accounts, as both dividend payouts and taxes are linked to this reported earnings number.

B. *Institutional differences and constraints on earnings management*

Opportunities to manage earnings (through accounting decisions) depend on how flexible the accounting standards are according to which financial statements are established, together with the degree of enforcement of those standards by the authorities. It is difficult to draw general conclusions about differences in flexibility and enforcement between Anglo-Saxon and non Anglo-Saxon countries. It is interesting to note that there exist large differences, for example, between US and UK accounting standards (both Anglo-Saxon countries). The latter are considered to be less detailed and allow more flexibility (see for example Ball et al. (1997)). Further is earnings management through accounting decisions in the US restricted by the severe scrutiny of the Securities and Exchange Commission (SEC). In non Anglo-Saxon countries the law specifies accounting rules in great detail (law-based accountancy). It is however common knowledge that in some of these countries (for example, Germany) earnings that are calculated according to local GAAP are managed through provisions. This would be rather rare in the Anglo-Saxon world (see for example Nobes and Parker (1995), p.47-48). Note also that earnings cannot only be managed through accounting decisions, but also through investment decisions (for example asset disposals).

Opportunities to manage earnings may also be different due to differences in ownership structure. Prior Anglo-Saxon research reported that ownership structure acts as a constraint on earnings management. The direction of the impact of ownership on earnings management in a typical non Anglo-Saxon setting is not clear. Concentrated ownership and hence closer monitoring by shareholders (see for example Burkart et al. (1997), p. 694) may constrain earnings manipulation. However, majority shareholders (which have internal information) may also have incentives to manage earnings in order to transfer wealth between them and users of financial statements (small shareholders and government) who have no access to internal financial information. Therefore, it may well be that concentrated ownership no longer functions as a constraint on earnings management.

Further, it is not clear whether audit quality will function as a constraint on earnings management in non Anglo-Saxon countries. From Anglo-Saxon studies there is evidence that audits performed by Big Five auditors constrain earnings management more than audits performed by non Big Five auditors. In our view, there are two competing hypotheses with respect to the impact of audit quality on earnings management in non Anglo-Saxon countries. The first hypothesis is that, since Big Five auditors are part of an international (American) group with standardized audit procedures, a similar audit quality level will be provided by Big Five audit firms across the world. Therefore audit quality will work equally well as a constraint on earnings management in non Anglo-Saxon countries. We believe that this hypothesis may hold to be true for non Anglo-Saxon firms which are listed and/or are operating internationally. A competing hypothesis is the following. As stock markets are less developed in non Anglo-Saxon countries and auditing is mandatory for closely held companies which meet certain legal form and size criteria, audit demand has a different origin in non Anglo-Saxon countries. Many firms, in particular closely held firms and firms which are not operating internationally, only demand auditing because it is mandatory and less so for agency or signaling reasons. Because of lack of voluntary audit demand, firms will try to fulfill this requirement as cheaply as possible and demand a (relatively lower) level of audit quality which just meets legal requirements. As a result many closely held firms and firms which are not operating internationally appoint non Big Five auditors because they are typically cheaper[9]. Big Five auditors are currently putting effort in increasing their market share in this market. However, to be succesful in this effort Big Five auditors will have to be price competitive with local auditors. A valid question is whether their service will still be quality differentiated from the other suppliers in that market. Empirical evidence is needed to test which hypothesis holds to be true[10].

V. SUMMARY

This paper presented (1) a review of the empirical earnings management literature, (2) a discussion of the institutional differences between Anglo-Saxon and non Anglo-Saxon countries and (3) a critical assessment of the impact of institutional differences on earnings management.

Empirical earnings management studies, which are mainly based on Anglo-Saxon data, examine the incentives for, constraints on and consequences of earnings management. Explicit contracts (such as bonus plans and debt covenants) as well as implicit contracts were found to induce earnings management. Evidence also suggests that earnings are managed (1) to communicate private information to investors about future firm value, (2) to sell stock for a higher price or (3) to raise additional financing on more favorable terms. Further, the political and regulatory process, and some specific circumstances (such as labor union contract negotiations, proxy contests, and earnings decreases or losses) induce earnings management. The evidence on earnings smoothing is mixed.

There is some evidence that prior accounting decisions, ownership structure, audit committees and internal governance (especially some characteristics of the board of directors) constrain earnings management. Audit quality was found to constrain within GAAP earnings management. Evidence on its impact on non-GAAP earnings management is, however, mixed. There is conflicting evidence on whether investors can be "fooled" by earnings management in the short run. Even if so, (1) the cost of capital increases or (2) stock performance declines once earnings management is revealed. Also the informativeness of accounting earnings may be reduced.

As major differences exist between non Anglo-Saxon and Anglo-Saxon countries, it may well be that results of Anglo-Saxon studies do not hold in continental Europe. In particular, we argue that earnings management induced by external contracts or a firm's relation with capital markets may be less important, whereas incentives created by the political and regulatory process and implicit contracts may be especially important. Also income smoothing is claimed to be important in continental Europe, but the incentives may be different. Further, we question whether in continental Europe, a firm's ownership structure and the quality of its auditor may constrain earnings management. Further research in continental Europe is needed to test these views.

NOTES

1. Note however that also in Anglo-Saxon countries, publication of financial statements is mandatory for some types of firms (e.g. listed firms in the US).
2. Note though that in the US the SEC (Securities and Exchange Commission) has legal power to establish accounting principles, but has delegated this to the accounting pro-

fession. However, the profession cannot ignore the opinion of the SEC (Baker, Rapaccioli and Solomon (1995)).
3. Note that the European commission abandoned the idea of setting European Standards and decided to support the IASC (Zeff (1999)).
4. A notable example for Belgium are the 1997 consolidated financial statements of Petrofina.
5. See Zeff (1999) for more detail on the IASC harmonization program, its core standards project and its relation with IOSCO and SEC.
6. The obligation to issue group accounts is subject to certain size criteria
7. Note however that tax assessment is likely to remain a purpose of financial reporting in non-Anglo-Saxon countries (FEE (1997) p. 12). Information provision through financial reports may be biased because of the tax influence. But, as (1) tax is usually assessed on the basis of the profits in individual financial statements and (2) information needed by capital markets is normally provided by consolidated ones, financial transparency can be achieved by eliminating the tax effect in consolidated financial statements (FEE (1997) p. 12).
8. Differences in contracting practices may also be related to differences in legal settings. Leuz et al. (1998), for example, conclude that in the US accounting based payout restrictions are included in debt contracts (i.e. the debt covenants) whereas in Germany they are mainly mandated (i.e. restricted by law).
9. Francis (1984), Palmrose (1986), Francis and Simon (1987), Chan et al. (1991), Francis and Stokes (1986) found for example evidence of a big-five price premium in (1) both the large and small auditee segments of the (US, UK or Australian) audit market, or (2) the small auditee segment alone.
10. Vander Bauwhede and Willekens (1998) for example could not find a difference in (the amount of) discretionary accruals, which is a measure of earnings management, between clients of big Five vs non-big Five audit firms in Belgium.

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