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Financial reporting incentives for conservative accounting: The influence of legal and political institutions ☆

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Abstract

This paper explores financial reporting incentives created by an economy's institutional structure. The underlying premise of our analysis is that a country's legal/judicial system, securities laws, and political economy create incentives that influence the behavior of corporate executives, investors, regulators and other market participants. Further, such incentives ultimately shape the properties of reported accounting numbers. We empirically analyze relations between key characteristics of country-level institutions and the asymmetric recognition of economic gains and losses into earnings (i.e., conditional conservatism). We also provide evidence on channels through which specific institutions manifest their influence on observed conservatism.
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1. Introduction

In this paper, we explore how reported accounting numbers are shaped by the institutional structure of the country in which firms are domiciled. We seek deeper understanding into the nature of financial reporting incentives created by an economy's institutional structure. We focus on financial reporting incentives related to accounting conservatism. To this end, we empirically analyze relations between key characteristics of economy-level institutions and one dimension of accounting conservatism, the asymmetric recognition of economic gains and losses into earnings, and provide evidence on channels through which specific institutions manifest their influence on observed conservatism.[1] Channels investigated include the use of accounting numbers in designing debt and compensation contracts, in supporting securities-related litigation, in motivating the behavior of public-sector regulators, and in mediating the relations between politicians and private sector business firms.

The underlying premise of our analysis is that a country's legal/judicial system, securities laws, political economy, and tax regime create incentives that influence the behavior of corporate executives, investors, regulators and other market participants. Such incentives shape the properties of reported accounting numbers through a complex interplay of accounting standards, legal, market, regulatory, and political pressures, and reporting discretion exercised by managers. Thus, a complete understanding of the realized properties of accounting numbers, including conservatism, must incorporate the influence of financial reporting incentives generated by existing institutions.

The persistent influence of conservatism on accounting practice suggests that it confers benefits to economic agents who use, prepare or regulate financial reports.[2] To investigate the sources of these economic costs and benefits, we extend earlier cross-country research (e.g., Ball et al. (2000) and Ball et al. (2003)) examining the association between country-level institutions and conservative accounting practices. Following Holthausen (2003), we take a more quantitative approach towards classifying the countries used in these comparisons.

With respect to countries' legal/judicial systems, we find that investor protections embodied in corporate law and the efficiency and impartiality of the judicial system play a significant role in creating incentives for timely loss recognition. Firms in countries with strong investor protections and high quality judicial systems reflect bad news in reported earnings numbers in a more timely fashion than firms in countries characterized by weak investor protections and low quality judicial systems.

Further, we examine the impact of securities law on conservatism, disaggregating securities law into two distinct dimensions: public enforcement and private enforcement aspects.[3] We find that firms in countries with strong public enforcement characterized by an independent, powerful, public enforcer slow the recognition of good news in reported earnings numbers relative to firms in countries with weak public enforcement. This result is

[1]Accounting conservatism is commonly conceptualized as an asymmetric degree of verification required to recognize good news as gains relative to that required for recognizing bad news as losses (e.g., Basu, 1997; Ball et al., 2000; Watts, 2003a).

[2]For example, Basu (1997) notes that conservatism has influenced accounting practice for at least five hundred years, and Sterling (1970, p. 256) stresses the highly influential impact of conservatism on the principles of valuation in accounting.

[3]We discuss these two aspects in detail in Section 2 of the paper.

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