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Investor protection, prospect theory, and earnings management: An international comparison of the banking industry

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Abstract

This paper raises three issues related to the *earnings* management (EM) of banks across 48 countries. First, does *earnings* management of banks exist in all 48 countries? Second, what is the incentive of banks to manage earnings? Third, why does EM vary across countries? To answer these three questions, two thresholds (viz., a threshold of *zero earnings* and a threshold of *zero earnings change*) are employed.

The answer to the first question above is that banks in more than two-thirds of the 48 countries sampled are found to have managed their earnings. With respect to the second question, prospect theory is used to provide an answer. The relationship between return and risk is positive for high earnings groups, but is negative for low earnings banks. Finally, as to the last question, stronger protection of investors and greater transparency in accounting disclosure can reduce banks' incentives to manage earnings. Also, higher real GDP per capita decreases the degree of earnings management. It is seen that stronger enforcement of laws can counter intuitively result in stronger earnings management. However, this effect appears in low-income countries only, and not in high-income countries.
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1. Introduction

Recent allegations of accounting fraud at Enron, followed by similar allegations at WorldCom, Xerox, Royal Ahold, HealthSouth, and so on, have triggered a closer examination of the topic of earnings management. Schipper (1989) and Healy and Wahlen (1999) state that earnings management is the alteration of firms' reported economic performance by insiders to either "mislead some stakeholders" or to "influence contractual outcomes". For instance, insiders can use their discretion in financial reporting to overstate the true level of earnings and hide unfavorable earnings realizations (e.g., earnings losses or earnings decreases) that would prompt outsiders to take action against insiders. In the presence of extensive earnings management, financial reports inaccurately reflect firm performance and consequently weaken outsiders' ability to govern the firm (Leuz et al., 2003).

To inferentially measure the extent of earnings management, Degeorge et al. (1999) and Burgstahler and Dichev (1997) present evidence that managers of US firms use accounting discretion to avoid reporting small losses. Employing annual earnings (scaled by beginning market value) on US firms for the years 1976–1994, Burgstahler and Dichev (1997) demonstrate a relatively smoothed single-peaked, bell-shaped distribution except in the area of zero earnings. Their graph of "drop-at-zero" is reproduced in panel A of Fig. 1 where earnings slightly less than zero occur much less frequently than would be expected given the smoothness of the remainder of the distribution, and earnings slightly greater than zero occur much more frequently than would be expected. The evidence suggests that firms manage reported earnings so as to avoid losses in earnings when losses are small. Namely, while non-financial firms can hide small losses, they cannot hide big losses. Burgstahler and Dichev (1997) also find that managers of US firms use accounting discretion to avoid reporting small earnings decreases. Degeorge et al. (1999), using statistical earnings management measures, also find evidence of earnings management that exceeds each of three "thresholds": reported positive profits, sustained recent performance, and the meeting of analysts' expectations.

While the above studies provide convincing evidence of earnings management, their samples typically exclude financial institutions and firms in other regulated industries, such as the utility industry. As to Burgstahler and Dichev's (1997) viewpoint, for regulated firms, conflicting incentives to report lower earnings or decreases in earnings arise whenever there are economic benefits from reporting lower earnings to regulators; for financial institutions, incentives to avoid earnings decreases or losses may be (negatively) linked to (the extent of) regulatory oversight. While the

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