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# Accounting standards and value relevance of financial statements: An international analysis ☆

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**Abstract**

Using 17,743 firm-year observations of industrial companies in 21 countries from 1991 to 1997, this paper finds that the use of accrual accounting (versus cash accounting) negatively affects the value relevance of financial statements in countries with weak shareholder protection. This negative effect, however, does not exist in countries with strong shareholder protection. These findings are consistent with the belief that shareholder protection improves the effectiveness of accrual accounting, and suggest the importance of considering shareholder protection when formulating accounting policies related to accruals. 

*JEL classification:* G15; M41

*Keywords:* International financial reporting; Accounting standards; Accrual accounting

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## 1. Introduction

This paper investigates the relation between accrual accounting and the value relevance of accounting measures in countries with different levels of shareholder protection. This issue is important because accrual accounting, which transforms cash flows into earnings, is a key feature of any accounting system. The study finds that stronger shareholder protection, an institutional factor characterizing a country's corporate governance environment (La Porta et al., 2000), improves the effectiveness of the accrual system. This finding suggests the importance of considering shareholder protection when formulating accounting policies related to accruals.

Accrual accounting provides better matching of revenues and expenses than cash accounting and therefore makes accounting information more value relevant. However, accrual accounting also presents more opportunities for managers to manipulate accruals for personal gain and hence may cause accounting information to be less value relevant. Consequently, an accounting system mandating more accrual accounting (hereafter, referred to as 'a higher use of accrual accounting') has offsetting effects on the value relevance of accounting information.

I argue that managers are more likely to behave opportunistically in an environment with weak shareholder protection (La Porta et al., 1997). Since a higher use of accrual accounting provides managers with more opportunities to manage earnings and poor shareholder protection exacerbates this managerial propensity, I predict that a higher use of accrual accounting negatively affects the value relevance of accounting information in markets with weak shareholder protection. In addition, since strong shareholder protection deters managers from manipulating accruals, I predict that strong shareholder protection will attenuate this negative impact.

Using 17,743 firm-year observations of industrial companies in 21 countries from 1991 to 1997, I test the impact of accrual accounting on the value relevance of accounting numbers for countries with different levels of shareholder protection. I measure a country's use of accrual accounting by the frequency of accrual-related accounting standards and evaluate the level of shareholder protection by antidirector rights and legal system (La Porta et al., 1996; Ball et al., 2000a,b). Following prior studies, I define the value relevance of financial statements as the ability of accounting data to summarize information impounded in market prices (Chang, 1998; Francis and Schipper, 1999). As in Chang (1998), I focus on two summary accounting performance measures from financial statements: earnings and return on equity (*ROE*).[1]

[1] This study does not address operating cash flows because the use of accrual accounting only affects earnings, not cash flows.