Available online at www.sciencedirect.com

ScienceDirect

The International Journal of Accounting 50 (2015) 316 – 339

The International Journal of Accounting

The Effects of Corporate Governance and Product Market Competition on Analysts' Forecasts: Evidence from the Brazilian Capital Market☆

José Elias Feres de Almeida[a,*], Flávia Zóboli Dalmácio[b]

[a] *Department of Accountancy, Federal University of Espírito Santo, Av. Fernando Ferrari, 514, CCJE, ED-VI, r. 618, Goiabeiras, 29075-910, Vitória, ES, Brazil*

[b] *Department of Accountancy and Actuarial Sciences, University of São Paulo, Ribeirão Preto Campus, Av. Dos Bandeirantes, n. 3900, r. 3., Monte Alegre, 14040-905, Ribeirão Preto, SP, Brazil*

Received 6 January 2015
Available online 29 July 2015

Abstract

We investigate how the interaction between product market competition and firm-level corporate governance enhances the accuracy of analysts' forecasts and reduces the forecasts' deviation. Using a sample of Brazilian public firms covered by analysts, we find that competitive industries provide incentives to increase the flow of information, but not necessarily to enhance its quality. However, strong corporate governance enhances the financial reporting process and consequently the quality of analysts' forecasts. Our main evidence shows that the analysts who cover firms in more highly competitive industries with strong corporate governance are the most accurate.

Keywords: Product market competition; Corporate governance; Accuracy of analysts' forecasts

☆ We appreciate the helpful comments from seminar participants at the EAA 2013, especially to John M. Barrios (University of Miami), Gerlando Lima (University of São Paulo), Amaury Rezende (University of São Paulo), Patricia Maria Bortolon (Federal University of Espírito Santo), two anonymous reviewers of TIJA Symposium 2014 and the participants for their comments and suggestions. We are especially grateful to our discussant Suresh Radhakrishnan (University of Texas at Dallas) for his valuable comments at TIJA Symposium, the editor A. Rashad Abdel-Khalik and the anonymous reviewers for their excellent contributions. José Elias Feres de Almeida also thanks the financial support from FAPES (Fundação de Amparo à Pesquisa do Espírito Santo).
* Corresponding author.
E-mail addresses: jose.e.almeida@ufes.br (J.E.F. Almeida), flaviazd@usp.br (F.Z. Dalmácio).

http://dx.doi.org/10.1016/j.intacc.2015.07.007

1. Introduction

We investigate how the accuracy of analysts' forecasts is improved by product market competition and firms' corporate governance attributes. The literature on industrial organization and corporate governance supports the underlying premise of our analysis that product market competition increases the flow of information to the market and, when combined with strong firm-level corporate governance attributes, these forces align the interests of insiders and outsiders, reducing the costs of obtaining private information (Bushman, Chen, Engel, & Smith, 2004; Dhaliwal, Huang, Khurana, & Pereira, 2014; Greenwald & Stiglitz, 1990; Lopes & Walker, 2008; Stiglitz, 2002).

The quality of the information disclosed to the market conveys a signal that is interpreted differently by each economic agent, leading to different decisions. For example, in interpreting an item of information issued by a firm, a competitor may interpret it in one direction, while an analyst may interpret the signal in the opposite direction; hence, "imperfect information affects both the internal organization of firms and its external relations with labor, capital, and product markets" (Greenwald & Stiglitz, 1990, p. 164).

The presence of imperfect information provides increased market power, which is exploited by firms to increase their market share or to strategically differentiate themselves from each other because of their different costs of obtaining information (Stiglitz, 2002). In this case, the quality of accounting information is affected by the incentives arising from the intensity of competition, which in turn affects the degree and direction of management's discretionary decisions (Dhaliwal et al., 2014) to act in their own interests or to improve the information disclosed to the market (Ali, Klasa, & Yeung, 2014).

For example, Cheng, Man, and Yi (2013) conjecture that firms in less competitive industries are associated with lower-quality accounting information. Their results suggest that different channels, such as product market competition, filter the accounting information disclosed by firms and that competitive industries can improve earnings quality. Dhaliwal et al. (2014) similarly show that high product market competition improves conditional conservatism; in other words, there is more efficiency in contracts among firms in a highly competitive environment, which increases the pressure on firms to disclose private information to the market. However, there is a growing demand in the literature to understand the relationship between product market competition and the role of analysts as informational intermediaries (Ali, Liu, Xu, & Yao, 2012; Li, 2010).

Product market competition enhances agents' ability to compare firms in the same industry (Nalebuff & Stiglitz, 1983). Thus, competition in the industry combined with increased comparability of firms' information will enhance the quality of analysts' forecasts (Ali et al., 2012; Li, 2010). The theoretical perspective is that the degree of competition is related to the flow of information from firms to the market; however, the type of competition might lead firms to disclose opaque information (Cheng et al., 2013).

Another channel that improves earnings quality is corporate governance. The literature shows that strong corporate governance contributes to enhanced earnings quality and reduces earnings management practices that distort firms' real economic performance (Bushman et al., 2004; Lopes & Walker, 2008, 2012).