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The association between financial accounting measures and real economic activity: a multinational study☆

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Abstract

We investigate how cross-country differences in financial accounting standards affect the relation between financial accounting earnings and real economic value-relevant events that underlie those earnings. Based on previous research and economic theory we hypothesize that, because of differences in legal systems and the demand for accounting information, differences in legal protection for external shareholders, and differences in the degree of tax conformity in our sample countries, accounting earnings in the UK and the US will be more closely related to underlying economic activity than will accounting earnings in France and Germany. Empirical results are generally consistent with our hypothesis. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

This study investigates how cross-country differences in legal systems and the demand for accounting information, differences in legal protection for external shareholders, and differences in the degree of tax conformity affect the relation between financial accounting earnings and real economic value-relevant events that underlie those earnings.[1] We investigate how well a measure of aggregate financial accounting performance (return on assets) reflects real economic activity in five industrialized countries with different financial accounting principles: France, Germany, Japan, the UK, and the US. These five countries are chosen because they represent the principal types of accounting standard setting regimes throughout the world, and they are highly influential in the development of international accounting standards (Choi et al., 1999). If different accounting principles are employed to measure a company's performance, the reported results will be different even though the underlying economic activity may be the same. For example, in 1993 Daimler-Benz reported DM615 million net income under German GAAP, but a DM1,839 million net loss under US GAAP. However, it is not apparent ex ante which GAAP measure better reflects real economic events.

We rely on previous research and economic theory to develop hypotheses about differences in the relation between financial accounting earnings and real economic activity across countries. Our hypotheses are based on four sets of measures. First, following Ball et al. (2000), we look to the origin of the legal systems in our sample countries to classify the countries as following either a code-law or common-law legal tradition. We expect that the shareholder orientation of accounting standards in common-law countries, which focuses on resolution of information asymmetry, will result in accounting standards that reflect underlying economic events in a timely manner. Alternatively, the stakeholder orientation of code-law countries, where the focus is on developing a measure of corporate income that can be divided up by the government, creditors, employees, managers, and shareholders, is expected to weaken the relation between financial accounting earnings and real economic value-relevant events.

Second, we consider how well a country's legal system protects external investors (La Porta et al., 1997). We adopt three measures from La Porta et al.: the index of antidirector rights, the ratio of external capitalization to GNP, and the ratio of aggregate market capitalization to sales.[2] Strong external

[1] Theoretical and empirical links have previously been established between stock returns and real economic value-relevant events (Asprem, 1989; Chen, 1991; Chen et al., 1986; Fama, 1990).

[2] The index of antidirector rights measures shareholder rights. External capitalization measures the aggregate stock market capitalization not owned by the top three shareholders in the ten largest non-financial privately owned domestic firms in a country. The aggregate market capitalization to sales measures the median ratio of external capitalization to sales for all non-financial firms in a country.