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Analyst coverage, earnings management and financial development: An international study

François Degeorge [a], Yuan Ding [b,*], Thomas Jeanjean [c], Hervé Stolowy [d]

[a] Swiss Finance Institute, University of Lugano, Switzerland
[b] China Europe International Business School (CEIBS), Shanghai, China
[c] ESSEC Business School, France
[d] HEC Paris, France

ABSTRACT

Using data from 21 countries, this paper analyzes the relation among analyst coverage, earnings management and financial development in an international context. We document that the effectiveness of financial analysts as monitors increases with a country's financial development (FD). We find that in high-FD countries, increased within-firm analyst coverage results in less earnings management. Such is not the case in low-FD countries. Our results are economically significant and robust to reverse causality checks. Our findings illustrate one mechanism through which financial development mitigates the cost of monitoring firms and curbs earnings management.

1. Introduction

A large body of research explores the differences between financial systems worldwide and documents the positive effects of financial development: It boosts industry growth, the formation of new establishments, and capital allocation (Beck and Levine, 2002). It predicts capital accumulation and productivity improvements (Levine and Zervos, 1998). It is especially important for firms that depend on external financing (Demirgüç-Kunt and Maksimovic, 1998; Rajan and Zingales, 1998).

While the benefits of financial development appear to be well established, the detailed mechanisms through which these benefits are brought to bear are still largely unknown. Levine (1997) lists

* Corresponding author. Address: Department of Finance and Accounting, China Europe International Business School (CEIBS), 699, Hongfeng Road, Pudong, Shanghai 201206, China. Tel.: +86 21 2890 5606; fax: +86 21 2890 5620.

E-mail addresses: francois.degeorge@lu.unisi.ch (F. Degeorge), dyuan@ceibs.edu (Y. Ding), jeanjean@essec.edu (T. Jeanjean), stolowy@hec.fr (H. Stolowy).

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five basic functions of a financial system: (1) to facilitate risk sharing; (2) to allocate resources; (3) to monitor managers; (4) to mobilize savings; and (5) to facilitate the exchange of goods and services.

Our paper's contribution is to focus on the monitoring function; specifically, on financial analysts as monitors of firms. We find that higher financial development is associated with a greater effectiveness of monitoring by financial analysts. Using a sample of 21 countries from 1994 to 2002, we find that in countries with highly developed financial systems (hereafter "high-FD countries"), increased within-firm coverage results in less earnings management. Such is not the case in countries with less well-developed financial systems (hereafter "low-FD countries").

There is evidence, both systematic and anecdotal, that financial analysts perform an important monitoring role, at least in the United States. Dyck et al. (2010) document that, in the US, financial analysts are among the quickest detectors of fraud. For example, in the mid-1990s Sunbeam, an appliance manufacturer, engaged in "bill-and-hold" deals with retailers: The retailers bought Sunbeam products at large discounts, but the products were then stored by the manufacturer at third-party warehouses for later delivery. In effect, Sunbeam was shifting revenue from the future to the present. The first warning to shareholders that Sunbeam was engaging in extensive earnings management came from a PaineWebber analyst, who noticed unusually large increases in sales of Sunbeam electric blankets in the summer and outdoor barbecue grills around Christmas time (Byrne, 1998).

The Sunbeam example illustrates a broader pattern. Using US data, Yu (2008) finds that earnings management tends to be lower in companies followed by more financial analysts. It is not hard to see why this might be so. Analysts have plenty of opportunities to probe a company's accounts to see whether they paint a fair picture of the company's true health. Provided they perform their duties with a modicum of diligence, the very fact that they are watching can in itself be a deterrent to earnings management and other activities that might embarrass corporate management. All else being equal, a company followed by financial analysts has less leeway to manipulate its earnings.

Findings based on US data, however, do not necessarily apply to countries with lower levels of financial development. To monitor company managers, analysts must overcome severe hidden information and hidden action problems: Managers might hide negative information about the company's prospects; they might hide some of their actions if they fear retribution from investors; they might be unable to reveal positive information about the firm to investors. We expect these difficulties to be easier to overcome in more financially developed countries like the United States. Holding constant incentives to manage earnings, we discuss possible reasons for this difference: Greater transparency may facilitate analyst monitoring in high-FD countries; investor demand for analyst monitoring may be greater; firms' incentives to facilitate analyst monitoring may be larger; and the quality and depth of the financial analyst pool may be improved.

We measure the effectiveness of analyst coverage of managers by the impact of that coverage on earnings management by companies. We posit that if more analyst coverage results in less earnings management, then analysts are useful monitors of managers' actions; this leads to our first testable hypothesis. If a country's level of financial development enhances analyst monitoring, then the association between analyst coverage and earnings management should be more negative in more financially developed countries.

Not everyone shares the view that the presence of financial analysts reduces earnings management. On the contrary, financial analysts in the United States have been accused of encouraging earnings management by setting company managers targets that are impossible to meet – except by manipulating company performance (Levitt, 1998; Fuller and Jensen, 2002). If the weight of analyst opinion is greater in more financially developed countries, the analyst's target-setting role, and the associated pressure on companies to meet those targets, may also be greater (Brown and Higgins, 2001, 2005). According to this view, as one moves from low-FD to high-FD countries, companies would become more fixated on trying to meet or beat the analyst consensus benchmark; this reasoning produces our second testable hypothesis: Analyst coverage leads to more earnings management in more financially developed countries.

Using a sample of 21 countries from 1994 to 2002 and controlling both for firm incentives to manage earnings (through various firm characteristics like size, leverage and growth) and for earnings management variation among countries and industries (through firm fixed effects), we find support for our first hypothesis: Financial development is associated with more effective monitoring