Earnings Management: Empirical Evidence on value relevance and Income smoothing.

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CHAPTER 3: INSTITUTIONAL SETTING

3.1 INTRODUCTION AND PLAN OF THE CHAPTER

In the previous chapter we have defined earnings management, examined in which contexts it is likely to occur and how the flexibility of the reporting process allows the manager to convey information. In addition, it was argued that the flexibility in reporting could be used to attain certain targets for certain levels of earnings. What has been abstracted from in the previous chapter is the institutional setting and the underlying mechanics of the reporting rules and regulation that create the possibility to manage earnings.

This chapter will examine the importance of accounting systems. A flexible reporting environment allows for more latitude in making reporting decisions. When measuring earnings management it is necessary to examine the differences between country of origin of a model and the local sample. Especially, the suitability of the application of a model should receive extra attention, given the properties of the local system.

Most empirical research on earnings management focuses on Anglo-Saxon countries and especially the US. When applying methodology and models developed for the US it is important to pay attention to the differences between accounting in the US and the Netherlands. Rules and regulations in the Netherlands will be discussed relative to the US with regard to earnings management. For the empirical analysis the differences presented in this chapter are used to modify the earnings management proxies to incorporate the local institutional settings. The discussion will focus on three aspects: the regulatory institutions, the rules and regulations and the enforcement of the rules.
Plan of the chapter

The next paragraph will detail some of the aspects of the institutional accounting setting in the Netherlands in a comparative context. Paragraph 3.3 will briefly explain the institutional setting in the US. Paragraph 3.4 will compare the setting in the Netherlands with the US and infer the consequence for measuring earnings management. Finally paragraph 3.5 will summarize this chapter.

3.2 THE INSTITUTIONAL SETTING IN THE NETHERLANDS

Prior to 1970 financial reporting in the Netherlands was not regulated by law, except for some basic requirements. Various institutions, such as the employer’s organizations and scientific committees of political parties issued recommendations, which were implemented voluntarily by many firms. In 1970 the Act on Financial Reporting was published which became effective on May 1, 1971. Public companies (naamloze vennootschappen, NVs) and large co-operative societies were the first to be required to disclose and audit their financial statements. Eventually, the law applied to NVs, private companies (besloten vennootschappen, BVs), cooperative associations (coöperaties), and mutual guarantee associations (onderlinge waarborg maatschappijen).

The emphasis in the law was put on general acceptability and a true and fair view. The act became part of the civil code in 1976 (Book 2, Title 6) with some minor changes. More important was the transition from Title 6 to Title 8 because of the inclusion of the Fourth EC Directive. Title 9 which became effective on January 1, 1990 adopted EC directive 7. Since consolidated statements were already mandatory since the original 1970 Act on Financial Reporting the impact of the incorporation of the 7th Directive was minimal. Subsequent additions to Title 9 include specific requirements for financial institutions, the extension to foundations and associations.

10 A more detailed discussion of the history of accounting regulations in the Netherlands and the impact on financial accounting choices can be found in Mertens (1997) and Zeff et al. (1992).
and Dutch entities with a head office abroad but with their main activities in the Netherlands.

**Character of law**

The Civil Code emphasizes the basic principles of going concern, consistency, accruals, prudence, realization and individual valuation. In addition, there is the overriding article 362.4 that states that if insight requires so, the annual reports should let true and fair view prevail over the specific legal requirements and deviate from the specific requirements in the Civil Code while explaining the effects on financial position and earnings in the notes.

The Netherlands had a tradition of current cost accounting and the law allows both historical cost and current cost accounting. The importance of current cost accounting is decreasing.

According to Nobes and Parker (1998) the Netherlands can be typified as "...a combination of almost extreme permissiveness with high professional standards. The permissiveness is moderated by the EC standards but the high standards remain, especially under large listed firms." The emphasis is less on uniformity and more on insight in the financial position and results of the firm.

**Guidelines**

In the explanatory statement (Memorie van toelichting) of the original Act on Financial Reporting the Ministry of Justice expressed its expectation that the business community and the auditors examine the acceptability of the accounting policies. The Dutch Institute of Chartered Accountants (NIVRA), the joint employers' organizations and the Trade Union Federation created the Tripartite Accounting Standards Committee in 1971. In 1980 this was changed into the Council for Annual Reporting (Raad voor de Jaarverslaggeving, CAR). The CAR is comprised of representatives from the preparers and users of the financial statements and the auditing profession. The CAR publishes Guidelines. First Drafts Guidelines are issued for comments. After receiving comments they will become Guidelines.

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11 When references are made in this text to RJ Guidelines, the 1990 English version is used since this is the version which was of importance during the period of the sample.
The Guidelines come in two forms, Recommendations and Authoritative Statements. Applying the Authoritative Statements will normally result in the legally prescribed insight, although there may be well founded reasons to depart from them.

The powers of the CAR and the Guidelines are considerably less than those of the ASB in the UK and the American FASB. The Guidelines in the Netherlands have no legislative status but can be looked upon as a reflection of what is generally acceptable. Moreover, departures of the Guidelines do not have to be disclosed in the annual report. In the English version of the Guidelines for Annual Reporting (1990) it states: "The CAR does not pretend that the authorative statements in either draft or the definitive Guidelines are binding, in the way legal requirements are. In the final analysis it is for the courts to decide on the merits of each case what standards are to be considered generally acceptable for a specific set of annual accounts."

**Enforcement**

In the Netherlands, law allows interested parties to bring a case to the Company Division of the Court of Appeal (Ondernemingskamer, OK), with a possibility of further appeal to the Supreme Court. The OK is the alternative of a monitoring authority like the US Securities and Exchange Commission (SEC). The OK cannot act on its own initiative but has to wait until an interested party brings a case. Once a case is brought to the OK the scope is limited to the case that is brought forward. A ruling is restricted to the case even if an investigation uncovers unrelated issues. Bringing a case to the OK involves complex legal procedures that are costly and time-consuming legal procedures.

### 3.3 THE INSTITUTIONAL SETTING IN THE US\(^{12}\)

The 1933 and 1934 Securities Exchange Acts established the SEC. The SEC’s prime mission is to achieve and maintain stable and effective capital markets for securities traded in interstate commerce. The 1933 Securities Act required securities to be

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\(^{12}\) This paragraph is based on the Ninth Edition of the Accountants’ Handbook (1999) by Carmichael, Lilien and Mellman.
registered. The purpose of registration is to create a complete and widely available public record of the registrant and the securities. The 1934 Securities Act increased the requirements set forward in the 1933 Securities Act by requiring substantial ongoing disclosures about the corporation, its officers and directors, and its financial condition and results of operations and other activities. Thus, firms who have registered under the 1933 Act must submit quarterly reports (10-Q), annual reports (10-K) as well as ad hoc reports when crucial events occur. An important feature of the 1934 Securities Act is the emphasis on disclosure. The filed reports are examined for compliance with the disclosure requirements but there is no review of the merits of managers’ behavior.

Only listed firms with at least $10 million in assets and at least 500 stockholders fall under the jurisdiction of the SEC. However, the role as the regulator and protector of US capital markets has given it substantial influence over financial accounting practice.

The 1934 Act Securities gave the SEC specific authority to establish accounting principles for the registrants. This authority led to the issuance of Accounting Series Release (ASR) No. 4 in 1938, which stated that the principles used in the filings would have to enjoy “substantial authoritative support”. There are three divisions that primarily deal with financial accounting:

1. The Division of Corporate Finance (DCF)
2. The Office of the Chief Accountant (OCA)
3. The Division of Enforcement (DE)

Ad 1) The fundamental responsibility of the DCF is to process the filed documents when they are received from registrants and to determine whether they comply with the appropriate disclosure requirements. The staff of this division is composed of attorneys, accountants and financial analysts. The division is organized by industry. When the DCF staff encounters questions about the registrants’ filings the questions are mostly resolved using published GAAP or precedents established in earlier firm-years. Some registrants raise questions prior to filing.
When the cases are more complicated or when the issues are more ground breaking the DCF consults with the OCA.

Ad 2) The Commission's main advisor on financial accounting issues is the Chief Accountant who is appointed at the discretion of the SEC chairman. The OCA works with the DCF to solve problems in filings or prefilin questions. The criterion for the OCA is whether something has substantial authoritative support. The first step is to consult the authoritative literature and consult with the Financial Accounting Standards Board (FASB). It is also common for the OCA to have a meeting with representatives from the registrant. They also examine their own pronouncements and interpretations. The OCA aims at a solution that presents "full and fair disclosure". The solution is developed by the OCA together with the DCF. If the registrant objects to the solution it can make an appeal to the full Commission. In practice this seldom occurs since the Commission almost always supports its staff.

In addition, to resolving specific filing issues the OCA also advises the Commission on major policy matters. This involves preparing recommendations for new SEC rules and overseeing standard setters. In this oversight capacity the OCA mainly has a supervisory role and does not specifically dictate the positions that the standard setters should take.

Ad 3) The Division of enforcement (DE) is in charge of investigating violations of the statutes and regulations and recommending disciplinary action. Information about possible violations comes from both within the SEC and outside sources. When the violations are more than accidental or technical the DE is responsible for determining whether and how to pursue and for discovering the facts. Often the DE settles the cases and although the findings are made public the registrant neither accepts nor denies the allegations. Sometimes a settlement cannot be reached and a case is turned over to the court where the Enforcement staff fully cooperates with the US Attorneys office.
Standard Setting Organizations

The Financial Accounting Standards Board (FASB) is a unique organization in that it is a private organization that serves to protect the public interest. The FASB is endorsed by the SEC in ASR No. 150 (now codified in FR-1) as the source of “substantial authoritative support”. The main outputs of the FASB are the Statements of Financial Accounting Standards (SFAS). Since 1991 a two third majority is required to adopt a new SFAS. The SEC officially recognizes the authority of these statements in ASR No. 150. In addition, the statements are recognized by the Council of the American Institute of Certified Public Accountants as generally accepted accounting principles (GAAP). An auditor failing to comply with the FASB standards is in violation of AICPA Ethics Rule 203.

Scott (1996) notes that the FASB puts heavy emphasis on due process when setting standards. The standard setting process usually involves the following stages:

1. Preliminary evaluation of problems related to accounting and reporting standards;
2. Admission to the agenda of FASB;
3. Early deliberations;
4. Tentative solution;
5. Further deliberations;
6. Final resolution;
7. Subsequent review.

As a privately funded, nongovernmental entity, the FASB must depend for its authority and financing on the constituents it serves.

3.4 IMPORTANT DIFFERENCES BETWEEN THE NETHERLANDS AND THE US

In the Netherlands annual reports are obligatory for firms that meet the minimum size requirements, regardless of whether a firm is publicly traded. The Netherlands has an institutional setting that emphasizes insight and professional judgment.
Regulations allow substantial choice and if insight requires so the 'true and fair override' can be invoked to deviate from the specific legal requirements.

The Guidelines issued by the CAR have no legal status, and deviations are possible. In addition to the flexible regulations and the lack of mandatory standards the enforcement of accounting regulations is passive in nature. There is no institution that actively monitors annual reports for compliance. Only after a case is brought to the OK an investigation can be started, but the scope is limited to the specific charge that is brought forward by the interested party.

In the US on the other hand, regulations are strict and very specific. Disclosure and restriction of choice take precedent over true and fair view. There is no true and fair view override article. In fact it is specifically forbidden to deviate from the generally accepted accounting principles. Only publicly traded firms of a certain size are required to file annual reports. The SEC actively monitors the filings for compliance and will start an investigation if it finds irregularities or when outside parties bring a complaint to the attention of the Enforcement Division of the SEC.

Apart from the way that financial accounting is regulated and enforced and the nature of the regulations there are also substantial differences in the specific regulations. Some of the most important differences are listed below:

1. The firms included in the consolidated accounts. Contrary to the US the Netherlands requires the exclusion of group firms when inclusion would conflict with the true and fair view.

2. In the Netherlands it is allowed to capitalize research and development costs when certain conditions are met. In the US these costs should always be charged directly to income with the exception of computer software.

3. The Netherlands allows current cost accounting for tangible and financial fixed assets, whereas the US does not.

4. In the US goodwill is required to be capitalized and amortized over the useful economic life not exceeding 40 years. The Netherlands allows this method as well but has no limit to the useful life. In addition, it is allowed to charge goodwill against shareholders equity directly and to charge directly to the income statement.
5. Similar to tangible and financial fixed assets, inventories can be valued at current costs in the Netherlands, as opposed to the US where this method is not allowed.

6. In the US changes in accounting policy require recognition of the cumulative effect in net income in most cases. Although this method is acceptable in the Netherlands, firms prefer to recognize the effect directly in shareholders equity and adjustment of the comparative figures.

7. There are also major differences in the methods for pension accounting, accounting provisions for insurance obligations and dividend accounting.

The list above is just an overview of some of the major differences in financial accounting regulations between the Netherlands and the US. Vergoossen and Polman (1995) examined firms that report in Dutch GAAP and are listed with American Deposit Receipts in the US. These firms are required to file a 20-F report reconciling the differences between Dutch GAAP and US GAAP.

The results of the Vergoossen and Polman study show substantial differences in both reported net income and the shareholders equity between Dutch GAAP and US GAAP.

One of the main causes for the differences according to Vergoossen and Polman (1995) is the accounting for goodwill as direct movements in equity. Other factors are the valuation principles that are allowed for publishing rights, real estate and insurance company regulations.

3.5 SUMMARY AND DISCUSSION

The differences as described above are beginning to decrease. The Netherlands is slowly moving in a direction of more disclosure, stricter rules, international conformity and stronger enforcement.

Current developments are that IAS will most likely become mandatory in the Netherlands and other European countries in 2005 for listed firms. The Dutch
Guidelines of the CAR are currently adapted to IAS. The Minister of Finance expressed himself a proponent of enforcement of accounting regulation by the Stichting Toezicht Effectenverkeer (STE), the Dutch body that regulates the financial markets. These developments do not impact the empirical research in this thesis since they were not yet implemented over the sample period.

The Netherlands has a relatively permissive reporting environment with flexible regulations and limited enforcement and monitoring. The US on the other hand has very detailed regulations and strict enforcement. This difference in reporting environment has consequences for both earnings management and empirical analysis. The relative flexibility in the Netherlands provides Dutch managers with more room for discretionary adjustments. Since their degree of freedom relative to the US is larger, it is likely that they will use different methods to implement the adjustments. It is probable that in the Netherlands line items will be used more then accruals relative to the US since line items provide more discretion in a Dutch setting. Using US methodology in a Dutch setting without attention for differences in institutional setting will result in flawed empirical designs.

In sum, it can be concluded that the institutions, the regulations and the enforcement of these regulations differ substantially between the two countries. These differences also influence the latitude afforded in implementing an earnings management strategy. The stricter regulations and enforcement in the US are also likely to result in different manners in which an earnings management strategy is implemented.

Harmonization of accounting regulations is a slow process that still leaves substantial differences between the Netherlands and the US. These differences are slowly disappearing but are still substantial.