What Factors Influence Financial Statement Quality?
A Framework and Some Empirical Evidence

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I plan to contribute the following to the Euroconference:
1. Present a framework of the factors that influence financial reporting practice and the quality of the financial reports in continental European countries.
2. Discuss potential differences in the proposed "financial reporting" framework between Anglo-Saxon and Continental European countries. This will be partly based on the Vander Bauwhede and Willekens (2000) paper.
3. Present empirical evidence on the factors that influence earnings management in privately held Belgian companies. Those factors include: audit quality, board quality, taxes and external (private) debt financing. This discussion will be based on some findings of my doctoral research.
4. Discussion with participants on the proposed framework and empirical research.

Below, I briefly summarize each of those points.

1. **Framework of factors that may influence the quality of financial statements in continental European countries**
Potential factors that influence financial reporting are the following: management's decisions (which are influenced by various relations with stakeholders to the company), quality of external governance mechanisms (i.e. audit quality), quality of internal governance mechanisms (i.e. quality of the board of directors), regulation as to financial reporting and external and internal governance mechanisms. The framework we propose is summarized in Figure 1. A firm and its management engage in various business transactions with various stakeholder groups. Stakeholders can reduce the business risk of a particular relationship by informing themselves on various aspects of the company they are dealing with. “Regulation” (see, for example the fourth and seventh EC Directives) requires therefore that the firms

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prepare financial accounts, according to GAAP. Management makes then various accounting decisions. They decide, for example, on what accounting procedures to use (e.g. LIFO versus FIFO inventory valuation), on the level of various provisions and write-offs and on the timing of asset disposals. Management's accounting decisions result in a set of "preliminary" financial statements, which are unobservable to the public. In making financial reporting decisions, management should follow GAAP. GAAP is however not a rigid set of principles. A concern is then also that managers do not follow GAAP or use the flexibility that is inherent in GAAP to opportunistically manage the financial information, and so their relationships with various stakeholders to the firm. Users of financial information are then also subject to a certain "information risk". Various mechanisms were developed to reduce opportunistic behavior on the part of management, and so information risk. The preliminary set of accounts is for example subject to a screening by both the internal and external governance mechanisms, such as scrutiny by the board of directors, and a thorough examination by the firm's auditors. (Note that the latter is required by the fourth and seventh EC Directives). Directors and auditors may require that management make some adjustments to the "preliminary" financial statements. This then results in a set of observed financial statements that are used by various stakeholders to the firm, such as investors, creditors, suppliers, customers and employees. It is clear that the quality of the "observed" financial statements will depend on the quality of the alternative governance mechanisms that perform a certain screening of the decisions made by the companies' management. The quality of those governance mechanisms is by itself influenced by recommendations on good corporate governance (see for example the Cadbury committee in the U.K., the committee Petersen in the Netherlands, the committee Cardon in Belgium) and audit regulation (e.g. the Eight Directive of the EC). The observed set of financial statements are then used by various stakeholders to the firms, such as investors, creditors, suppliers, customers and employees. Note further that regulation itself is influenced by the preparers as well as users of the financial statements.

Some of those stakeholders (such as creditors) have likely superior knowledge in assessing the quality of those financial statements and can impose costs on the firms (e.g. through less favorable terms of trade) if they consider that the financial statements are of low quality. Also, any detection by the board of directors or the firm's auditors that management produced financial statements of lower quality (e.g. management did not follow GAAP or management used the flexibility that is inherent in GAAP aggressively) may result in loss of trust between those parties and the firm's management. This may then impose costs on management. They may rationally choose to avoid those costs by producing up front higher quality financial statements.

1 Note that relationships with management may induce firms to manage earnings opportunistically or to restrain their opportunistic behavior. What behavior occurs depends on the trade-off between the potential benefits and costs that follow from opportunistically managing earnings.
2. Factors that may influence financial reporting practice: differences between Anglo-Saxon and continental European companies

A review of the empirical earnings management literature (see for example Vander Bauwhede and Willekens 2000) has shown that a majority of research has been performed in Anglo-Saxon countries, and in particular the US, and on sets of quoted (i.e. publicly held) companies. The majority of companies in Europe are however privately held, and the institutional environment in which they operate are quite different from the Anglo-Saxon institutional environment. We therefore attempted to make a comparison of the major institutional and accounting characteristics along which Anglo-Saxon and non-Anglo-Saxon countries differ, and assess their potential impact on the factors that may influence financial reporting practice. Institutional and accounting differences include the legal system, ownership and financing structure, demand for and goal of financial reporting. The analysis of those differences resulted in the following observations.

American financial reporting research focuses on reporting choices of publicly-traded companies, follows an investor-oriented perspective and has paid a lot of attention to the consequences of agency and information problems that arise from dispersion between ownership and control. Factors that potentially influence financial reporting decisions in this context are relations with public capital markets and explicit contracts such as bonus plans and debt covenants. The majority of continental European countries by contrast are privately and closely held companies. For those companies, reporting choices are unlikely to be influenced by public capital market incentives and by problems that arise from dispersion between ownership and control. Stakeholders, other than investors (e.g. employees, creditors and tax authorities) are much more likely to have an impact on firms' financial reporting decisions (see, for example, Vander Bauwhede and Willekens 2000).

Also continental European audit markets are likely different from American audit markets. This may affect auditor behavior itself, and client firm's expectations about their auditor's behavior. Since European Directives require that a large number of European companies be audited, this may in turn affect the reporting behavior and financial statement quality of a large number of companies in Europe.

In addition, differences in ownership and financing structure between the US and continental European countries may also imply differences in internal and external governance systems (other than external auditors) that may influence the financial reporting process.

Note that a strict dichotomous classification of Anglo-Saxon versus non-Anglo-Saxon countries is not possible.
3. Empirical evidence on incentives for and constraints on earnings management by privately held Belgian companies

To date my research has focused on one particular aspect of financial reporting, that is earnings management, and in particular discretionary accruals management. We have examined the direct impact of public ownership on earnings management (Vander Bauwhede, Willekens and Gaeremynck 2000; Vander Bauwhede, Gaeremynck and Willekens 2000). In addition, we are performing a thorough empirical study on factors that may affect earnings management of privately held continental European and in particular Belgian, companies (Vander Bauwhede and Willekens 2001). The main factors examined are the quality and characteristics of firms’ external auditors, tax, and implicit contracts with various other stakeholders such as creditors, employees and suppliers.

We tested our hypotheses with respect to the factors that influence earnings management by regressing (an estimation of) the level of discretionary accruals on various proxies of factors that may explain the extent to which firms engage in earnings management.

We found that ownership status (public versus private ownership) has indeed an impact on firms’ financial reporting choices and in particular earnings management (Vander Bauwhede, Willekens, and Gaeremynck 2000). This suggests that factors that influence firms’ financial reporting decisions are likely different between public and private companies. In addition, we find that tax and the degree of reliance on external private debt finance influences the financial reporting (earnings management) decisions of privately held companies. We did generally not find that audit firm size is related to the level of earnings management. This contrasts prior empirical research and may, we believe, be explained by the relative absence of severe auditor litigation in continental European audit markets.

4. Discussion

Some potential questions that can arise from my discussion are:

1. What are potential other factors that influence financial reporting in European countries? Are there any differences across European companies?
2. How does the work of other participants fit into the proposed framework?
3. How can we measure financial statement quality in general, and earnings quality in particular? How can we measure audit quality and board quality?
4. Is there somebody who has similar conclusions as to the impact of audit quality on financial statement quality? And what are potential explanations for the relative absence of audit quality differentiation in my research?
References
Figure 1 Some factors that influence the observed quality of financial statements (Vander Bauwhede, 2001)