



SFB/Transregio 266

ACCOUNTING FOR TRANSPARENCY

Earnings Management and Investor Protection: Accounting Reading Group - Assignment III

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Humboldt-Universität zu Berlin – Summer 2024
2024-08-11

1. Motivation

1.1 Understanding Systematic Differences in Earnings Management across Countries

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- The paper of Leuz, Nanda, and Wysocki (2003) focuses on the relationship between investor protection and earnings management.
- Investor protection plays a crucial role in limiting the extent of earnings management by reducing the opportunities for managers to manipulate earnings.
- Analyzing the relationship between EM and investor protection across different countries provides insights into how legal and institutional frameworks impact financial reporting practices.
- Earnings management (EM) measures reflect the extent to which managers manipulate financial reports to meet certain objectives, such as meeting earnings targets or influencing stock prices.

1.2 Project Objective

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- The primary objective is to demonstrate a reproducible and collaborative research workflow by calculating and analyzing EM measures across different countries.
- The study aims to replicate and extend the findings of Leuz, Nanda, and Wysocki (2003), exploring the relationship between EM and investor protection using Worldscoop datasets for the time range 1990 to 1999.
- The analysis provides insights into the levels of earnings management across countries, comparing them with the original findings of Leuz, Nanda, and Wysocki (2003).

1.3 Project Relevance

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- Understanding EM trends across countries aids in assessing global financial transparency.
- Promotes transparency and reproducibility in empirical accounting research.

2. Research Design

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- Data sourced from the Worldscope Database (1990-1999) July 2024 version.
- Replication includes calculation of **four earnings management measures**:
 - 1 Earnings smoothing using accruals (EM1)
 - 2 Correlation between changes in accruals and cash flows (EM2)
 - 3 Magnitude of accruals (EM3)
 - 4 Ratio of small profits to small losses (EM4)

3. Assumptions

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- **Database Version:** Analysis uses the July 2024 Worldscope data, which may differ from the November 2000 version due to updates and restatements.
- **Key Terms:** Earnings management (EM) and investor protection defined as per Leuz, Nanda, and Wysocki (2003) for consistency.
- **Handling Negative Values:** Negative values in key metrics (e.g., operating income) were included to capture the full scope of EM activities.
- **Variable Selection:** Chose specific Worldscope variables (e.g., item1151 over item4051) based on best practices; differences may affect results.
- **Currency Consistency:** EM measures are based on scaled variables; currency consistency ensures comparability across countries.

3.0.1 Discretionary Accruals ##delete

- Are used in tons of papers
- As measurement constructs for almost everything
 - Earnings Management
 - Earnings Quality
 - Audit Quality
 - Management Quality
- But how do they look like?

3.0.2 Data - Replication Steps

Step 1: Pulling the Data and Managing the Databases

Step 2: Data Preparation

- To verify the robustness of descriptive statistics before the main replication, Table 1 from Leuz et al. was replicated, yielding results that closely align with the original study:

Country	# Firm-years
AUSTRALIA	2099
AUSTRIA	686
BELGIUM	932
CANADA	4215
DENMARK	1326
FINLAND	1058
FRANCE	5515
GERMANY	5307
GREECE	1034
HONG KONG	1862
INDIA	2068
INDONESIA	978
IRELAND	625
ITALY	1591
JAPAN	20528
KOREA (SOUTH)	2038
MALAYSIA	2283
NETHERLANDS	1782
NORWAY	1210
PAKISTAN	598
PHILIPPINES	574
PORTUGAL	577
SINGAPORE	1291
SOUTH AFRICA	1334
SPAIN	1221
SWEDEN	1766
SWITZERLAND	1553
TAIWAN	1259
THAILAND	1664
UNITED KINGDOM	12910
UNITED STATES	41585
Mean	3983
Median	1553
Min	574
Max	41585

Table 1: Replicated table - Descriptive statistics: Number of firm-year observations per country

3.0.3 Conclusion

- Significant differences in earnings management practices across countries.
- Strong alignment with original findings in Leuz, Nanda, and Wysocki (2003).
- **Future Work:** Repository can be cloned or forked for further analysis.

References

Leuz, Christian, Dhananjay Nanda, and Peter D. Wysocki. 2003. "Earnings Management and Investor Protection: An International Comparison." *Journal of Financial Economics* 69 (3): 505–27.
[https://doi.org/10.1016/S0304-405X\(03\)00121-1](https://doi.org/10.1016/S0304-405X(03)00121-1).