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Balance sheet versus earnings conservatism in Europe

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njos s/n,

¹As Basu notes, there is an exception to this rule.

¹⁰Results of comparative studies on earnings conservatism can be affected by differences in income smoothing (see Leuz et al., [2003](#)).

¹¹Basu et al. ([2001](#)) show that those firms audited by the Big Five (Six, Eight) auditing firms are more earnings conservative. Pope and Walker ([2003](#)) analyse how the understatement of shareholders' equity, as reflected in the market-to-book ratio, is affecting the measures of earnings conservatism. They find, for the US, that when the market-to-book ratio is small, earnings conservatism is more pronounced. Ryan and Zarowin ([2003](#)) analyse the relationship between earnings and returns, studying both the existence of earnings conservatism and of the prices leading-earnings phenomenon. Helbok and Walker ([2001](#)) analyse the implication of earnings conservatism on analysts' earnings forecasts. Beekes et al. ([2003](#)) analyse whether earnings conservatism measures vary with the composition of the board of directors, and similarly, Huijgen and Lubberink ([2001a](#)) link earnings conservatism with managerial incentives. Garrod and Valentincic ([2001](#)) argue that the asymmetry can be explained by shareholders' liquidation option. Giner and Grambovas ([2001](#)) analyse the existence of earnings conservatism in ten European countries showing that the degree of earnings conservatism is larger in case of monetary crisis. Raonic et al. ([2003](#)), focusing on European interlisted firms, argue that differences between European countries can be explained by several institutional factors. Chandra et al. ([2001](#)) examine conservatism in US high-tech firms. Finally, Huijgen and Lubberink ([2001b](#)) compare the former more co

¹²Although the 19th century and the 20th century are inconsistent with this



¹⁴We include Switzerland in our sample. We do not include Switzerland in our sample because it is not a member of the OECD. We do not include Switzerland in our sample because it is not a member of the OECD.

Table 1, we can see that there is a larger variability of all variables in Switzerland, to the extent that if we include Switzerland in the continental group, Swiss observations would behave as outliers, and drive the results for the whole group.

¹⁵Using bottom-line earnings we are closer to maintaining the clean surplus relation, which Feltham and Ohlson ([1995](#)) models assume. Additionally, we are also consistent with the definition of earnings that we find more appropriate to measure earnings conservatism.

¹⁶As in Feltham and Ohlson ([1995](#)), we assume a linear relationship between price and book value and earnings. Although empirical analysis of US data, i.e. Burgstahler and Dichev ([1997](#)), suggests that this relation is non-linear, this is beyond the scope of our study. Nevertheless, we believe that further research targeting this particular misspecification of the model should be encouraged.

¹⁷Our results obtained from applying the Fama and McBeth ([1973](#)) analysis should be interpreted with caution. The analysis by Fama and McBeth ([1973](#)) assumes that the relations between variables are stationary over time. However, in our theoretical analysis we assume that Western European countries are converging under the EU directives. Also, the aggregate market-to-book ratio increases systematically over time in most countries. Basu ([2001](#)) shows as well serious concerns about the results of the annual regressions of Fama and McBeth when used in capital markets-based accounting.

¹⁸To avoid the non-linearity of the relation between price and earnings, Feltham and Ohlson ([1995](#)), those observations with a market-to-book ratio smaller than one are excluded from the sample. In countries where the deflation is significant, the market-to-book ratio is smaller than one.

¹⁹We use the market-to-book ratio to control for the return on equity. The return on equity is calculated as the net income divided by the book value of equity. The return on equity is calculated as the net income divided by the book value of equity.

²⁰Giner et al. (2001) show that the size of the firm is positively related to the market-to-book ratio. Giner et al. (2001) show that the size of the firm is positively related to the market-to-book ratio. Giner et al. (2001) show that the size of the firm is positively related to the market-to-book ratio.

²¹Greater persistence of earnings is one of the possible explanations as to why the earnings multiple is smaller in continental countries compared to the UK. Other explanations include, for instance, differences in growth (although this is not supported by our empirical evidence) and risk. Results in other papers, like Ball et al. ([2000](#)) or Leuz et al. ([2003](#)), suggesting greater income smoothing in code-law-based countries are not necessarily contrary to our results. Income smoothing leads to greater earnings persistence, but this does not necessarily imply that earnings persistence in continental countries will be greater than in the UK.

²²We also check whether the total bad news effect ($\beta_2 + \beta_3$) is statistically significant. For earnings conservatism to exist, it is not only necessarily a significant incremental sensitivity of bad news with respect to good news, but also that the total effect of bad news is statistically significant. We analyse this extent through a Wald test, finding that the total bad news response coefficient is significantly positive in all countries.

²³In the case of the pooled regression, if we compare the UK with the group of continental countries and exclude Spain and Switzerland from the analysis, the significance of the difference between the UK and the continental group would increase. But still, we could not strongly argue that there are significant differences, particularly taking into account that when we use Fama and McBeth regressions the differential coefficient of bad news in continental countries with respect to the UK is close to

²⁴This re

²⁵This is (previous studies), t al. ([2000](#)) choose t conservative than Fra they do not test t y. Also, Giner es in their sample (327.



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