Louisiana's Distinct Legal System and its Effect on Earnings Management

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Abstract

This paper measures the degree to which managers engage in earnings management for firms incorporated in 28 U.S. states and compares Louisiana with the other 27 states. The motivation of this study is because Louisiana is the only U.S. state whose legal system is based on the French civil law. Previous research suggests that French civil law provides the weakest investor protection, while the common law provides the strongest investor protection. In addition, further research found that the legal system is a strong determinant of earnings management. More specifically, investor protection is negatively associated with earnings management. Four types of earnings management were compared, including earnings smoothing for poor performance, earnings smoothing to conceal economic shocks, earnings discretion measure: magnitude of accruals, and earnings discretion measure: small loss avoidance. Of the four measures, only one (earnings smoothing for poor performance) showed a clear distinction between earnings management in Louisiana and in other states. This measure focused on the degree to which managers would reduce the variability of reported earnings by altering accruals.

Keywords: earnings management, earnings smoothing, Louisiana law, investor protection

1. Introduction

Earnings management has been an important topic in the accounting research for decades. Healy and Wahlen (1999) provide the following definition for earnings management: "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." Due to its importance, several scholars have paid attention to earnings management by measuring it through various ways, such as through discretionary accruals (Jones, 1991; Dechow et al., 1995; Kothari et al., 2005; De Fond and Subramanyam, 1998; Teoh et al., 1998), or through real activities manipulation, including R&D expenditures (Bens et al., 2002) and operational activities (Roychowdhury, 2006).

There are various external factors that affect the degree to which managers engage in earnings management. Leuz et al. (2003) found that the legal system is a strong determinant of earnings management around the world. More specifically, they found that investor protection is negatively associated with earnings management because "strong and well-enforced outsider rights limit insiders' acquisition of private control benefits, and consequently, mitigate insiders' incentives to manage accounting earnings because they have little to conceal from outsiders." In addition, when comparing different legal systems, La Porta et al. (1998) found that the French civil law provided the weakest investor protection, while the common law provided the strongest investor protection, with the Scandinavian and the German civil laws residing somewhere in between[1].

[1] Although La Porta et al. (1998) uses the term French civil law (or German and Scandinavian), current literature regards this debate as code law vs. common law. So in our case, French civil law (or civil law in general) is the equivalent of code law in other research articles.

Based on these findings, one can reason that managers in firms located in countries characterized by civil law, such as in France, are more prone to engage in earnings management than managers in firms located in countries whose laws originate in the common law tradition, such as the United States of America.

The legal system of the United States, however, does not entirely cover all the states uniformly. We focus our study on the legal system of the state of Louisiana. Louisiana is the only state in the U.S. that has a mixed legal system but predominantly based on the French civil law tradition (Hood, 1958), while all other states of the U.S. have a legal system originating in the common law tradition. Consistent with La Porta's et al. (1998) findings in regards to the two different codes, we suspect that investor protection is weak in this state, and, consistent with the findings of Leuz et al. (2003), we suspect that this weakness in investor protection will create a greater incentive for managers in firms located in Louisiana to engage in earnings management. In our paper, the term "investor protection" will refer to shareholder protection. Creditor protection is assumed to not contribute to differences in the degree of earnings management because La Porta et al. (1998) found that creditor protection in the United States, an exception of countries under common law, is relatively weak, which is also true for countries under French civil law.

While previous studies have examined the association between French-civil law, investor protection and earnings management on a country level, no study has replicated the findings within the United States. Our study will focus on the degree that managers engage in earnings management in firms incorporated in Louisiana, and we will compare these firms with firms of other states of the United States. We argue that, based on the existing literature regarding the association between French-civil law, investor protection and earnings management, firms in Louisiana engage more in earnings management than firms in other states of the U.S.

The remainder of this paper is organized as follows: Section two focuses on the existing literature under which this study is based. Section three includes the methodology used to test our hypothesis. Section four lists the findings of our study. Section five concludes, while section six lists the limitations and areas for future research.

2. Literature Review

2.1 Common Law vs. French-Civil Law

La Porta et al. (1998) studied the differences of four legal systems, common law, French-civil Law, German-civil law and Scandinavian-civil law in terms of outside shareholder and creditor protection. For the purpose of this paper, we discuss only the differences between common law and French-civil law. Based on their study, La Porta et al. found that shareholders in common law countries have the strongest protection, which allows the voting by mail, has the highest incidence of laws protecting oppressed shareholder minorities, never blocks shares for shareholder meetings, and requires little share capital to call an extraordinary shareholder meeting. On the other hand, French-civil law countries have the lowest incidence of allowing voting by mail, a low incidence of not blocking shares for shareholder meetings, a low incidence of laws protecting oppressed shareholder minorities, and they have the highest percentage of share capital needed to call an extraordinary shareholders' meeting.

In terms of creditor rights, the common law countries in general do provide strong protection over managers. The United States, however, is an exception to these common-law countries. As La Porta et al. (1998) explain, such an exception is given because in the U.S. there are various procedures that weaken creditor protection, such as permitted automatic stay, and managers being able to keep their jobs in reorganization proceedings. Similarly, French-civil-law countries offer weak creditor protection, by having few cases of assuring that secured creditors are paid first, and relatively few cases of removing managers in reorganization proceedings. Therefore, in our paper we exclude the study of creditor protection for Louisiana and focus only on shareholder protection. So, the term "investor protection" solely refers to shareholder protection for the remainder of the paper.

2.2 Louisiana Law

Based on the differences described above, we base our research on the state of Louisiana because it is the only state in the United States whose legal system is mixed between French-civil law and common law. Tetley (1999) states that Louisiana, regardless of the fact that it had been recently purchased by the United States, managed to keep the French-civil law which was approved by Governor Claiborne as the Louisiana Civil Code of 1808. Tate (1977) describes the Code as basing 70% of its 2,156 article from the French Civil Code of 1804, and the remainder was influenced by the Spanish law, which is also derived by French-civil law.

The code was revised in 1870 to incorporate laws in regards to the abolition slavery, and was renamed to "Revised Civil Code of the State of Louisiana.".

The code was not revised since then for about a century, even though several articles were amended, repealed or added. (Hood, 1958) Only recently the Code has been revised, with the most important revision taking place in 1991, during which time the new Book IV on Conflict of Laws (Articles 3514-3549 c.c.) was added. (La. Acts No. 923.2, 1991) Therefore, Louisiana's legal system has its roots on the French-civil law despite being influenced throughout the years by the common law.

2.3 Louisiana Law and Investor Protection

While no previous research has explicitly focused on the various shareholder rights, certain characteristics of such rights need to be pointed out. First of all, Louisiana law seems to be very strict at allowing shareholders to call special meetings. In regards to how shareholders can vote, RS 12:75 states that shareholders are given the one-share-one-vote right, but this statute further states that "a shareholder shall have the right to cast his vote either in person or, subject to the following provisions, by proxy duly authorized in writing, signed by the shareholder and filed with the secretary at or before the meeting." It should be noted that the vote by the shareholder cannot be mailed, in contrast with the members of directors, which are allowed to do so under RS 12:232. In regards to shareholders being able to call special meetings, RS 12:73 states that shareholders can request a special meeting in writing only if they hold at least one-fifth of the total voting power. As for minority rights Morris (1995) compares the American Law Institute (A.L.I.) and Louisiana Code of Civil Procedure and states that A.L.I. allows shareholders to directly challenge directors' decisions in court. On the other hand Louisiana Law does not include such a law.

The rights of shareholders in Louisiana described above can provide an idea of whether investor protection is either strong or weak. Shareholders are better protected when dividends are linked to voting rights, which is related to the one-share-one-vote rule (Grossman and Hart, 1988). As described above, this rule is also applicable in Louisiana. La Porta et al. (1998) suggest that not allowing shareholders to vote by mail makes it difficult for them to exercise their vote. Louisiana allows voting by mail only for board members but not for shareholders, which shows a weak point in the investor protection under Louisiana law. Furthermore, La Porta et al. (1998) suggest that the higher the percentage of share capital required by a shareholder to call an extraordinary meeting leads to a weaker shareholder protection. Louisiana, with a requirement of one-fifth of total voting power falls in the higher end of the range, which weakens shareholder protection. Lastly, the lack of a rule that allows shareholders to directly challenge directors' decision in court, further weakens such shareholder protection.

2.4 Hypothesis

La Porta et al. (1998) found that countries whose legal system originated from the French-civil law provide the weakest investor protection. Based on their findings and the Louisiana laws described in the previous paragraphs, Louisiana civil law is comparable to the French civil law. More specifically, the Louisiana civil law does not allow shareholders to directly challenge directors' decision in court, which is also true for most of the countries under French civil law. Also, voting by mail, which provides another weakness on investor protection, is not allowed under Louisiana law, and it is the same for most countries under French civil law. Furthermore, the average of countries whose legal system originates from French civil law is the highest in terms of share capital required to call an extraordinary meeting, which is 15% (with the highest being Mexico, 33%). Louisiana's legal system requires that the shareholder should have one-fifth of total voting power, which translates to 20%, a percentage even higher the average of countries under French civil law. As for the one-share-one-vote rule, Louisiana shows that it provides some investor protection, but this rule is true also under French civil law and this legal system is still considered the weakest.

The findings of the study conducted by Leuz et al. (2003) show that the degree of investor protection is related to the earnings management by managers. They argue that when outsider rights are strong and well-enforced, they can reduce the ability of insiders to acquire private control benefits. Consequently, this mitigates insiders' incentives to manage accounting earnings because they have little to conceal from outsiders. This argument is also consistent with the findings of Nenova (2003) as well as Dyck and Zingales (2004) which show that an increase in investor protection decreases private control benefits.

Therefore, accounting for all the similarities found between Louisiana civil law and French civil law in regards to investor protection, and regardless of the former legal system being influenced by the common law, we argue that firms located in Louisiana, when compared to firms in other states of the U.S., are more prone to engage in earnings management.

So, our hypothesis is as follows:

H1: Incentives for accrual earnings management are greater for firms in Louisiana than for firms in other U.S. states.

3. Methodology

3.1 Data Collection

The data has been obtained from COMPUSTAT North America. The population sample is the firms listed in this database from 1997-2012. Originally, the data consisted of 177,344 firm-year observations. After excluding financial institutions, we were left with 87,452 firm-year observations. Missing values were dropped listwise because we wanted to have data for each firm in order to calculate the accruals value. After the exclusion of observations with missing values, we were left with 79,452 firm-year observations. In order to test the effects of earnings management, we require that each firm should have at least three consecutive years of available balance sheets and income statements. After deleting firms-year observations that did not have two previous consecutive years in terms of annual reports (a step done in the data filtering process to ensure that all firms had at least 3 consecutive years), as well as dropping one year to ensure we could calculate lagged variables for each observation, firm-year observations went down to 58,657 for a year range of 2000-2012. Then, due to state-specific legal differences, we exclude the state of Delaware. After this exclusion, we are left with less than half of the observations, or 28,455. After excluding firms that did not have a listed state of incorporation in COMPUSTAT, we brought the firm-year observations to 20,296. Lastly, we use states that have more than 150 firm-year observations, so after dropping such states our final sample size is 19,097. Table 1 lists the states used in this study and the number of firm-year observations for each state.

Table 1: States and Their Firm-Year Observations for the Period 2000-2012

	State	Firm-Year Observations per State
1	California	1423
2	Colorado	792
3	Connecticut	174
4	Florida	1093
5	Georgia	366
6	Illinois	289
7	Indiana	485
8	Kansas	154
9	Louisiana	168
10	Massachusetts	711
11	Maryland	345
12	Michigan	437
13	Minnesota	1265
14	Missouri	301
15	North Carolina	383
16	New Jersey	635
17	Nevada	2904
18	New York	1297
19	Ohio	1008
20	Oklahoma	207
21	Oregon	407
22	Pennsylvania	961
23	Tennessee	278
24	Texas	1000
25	Utah	416
26	Virginia	534
27	Washington	551
28	Wisconsin	513

3.2 Four Ways of Measuring Earnings Management

In this study we measure the degree of earnings management for firms in Louisiana and firms in other states of the United States. Based on Leuz et al. (2003), we use four ways of measuring earnings management. The first two ways focus on earnings smoothing measures while the other two ways focus on earnings discretion measures.

3.2.1 Earnings Smoothing for Poor Performance

The first measurement focuses on the variability of reported earnings. Managers can reduce this variability by manipulating the accounting component of earnings, which are accruals, and therefore conceal changes in the company's economic performance. So, the measurement for this portion is done by examining the degree of earnings smoothing through the manipulation of accruals. Following Dechow et al. (1995), we use the following model to measure the accrual component of earnings:

$$Accruals_{it} = (\Delta CA_{it} - \Delta Cash_{it}) - (\Delta CL_{it} - \Delta STD_{it} - \Delta TP_{it}) - Dep_{it}$$

In this model, ΔCA_{it} represents the change in total current assets, $\Delta Cash_{it}$ is the change in cash or cash equivalents, ΔCL_{it} is the change in total current liabilities, ΔSTD_{it} is the change in the short-term debt included in current liabilities, ΔTP_{it} represents the change in income taxes payable, and Dep_{it} is the depreciation and amortization expense. The letters *i* and *t* translate to firm *i* in year *t*. The short-term debt is deducted from current liabilities because this portion is related to financing transactions and not operating activities.

After calculating the accrual value for each firm-year observation, we calculate the cash flow from operations by subtracting the accrual portion from operating income. Then we calculate the standard deviation on a firm level for both operating income and cash flows, and we scale these values by lagged total assets. The next step is to calculate the state's median ratio of the standard deviation of operating earnings divided by the standard deviation of cash flow from operations measured above. The use of cash flow from operations as a scaling instrument allows for control on changes in the variability of performance across companies. Measuring low values of this ratio indicates that managers are engaging in earnings management to smoothen earnings.

3.2.2 Earnings Smoothing to Conceal Economic Shocks

Managers also try to manipulate earnings so that they can cover economic shocks from cash flows from operations. They either over-report or under-report current performance in order to cover poor current performance or to accumulate reserves for the following year, respectively. This results in a negative correlation between accruals and cash flow. Therefore, for this portion of the study we compare the state-level correlation between the change in accruals and the change in cash flows from operations. We use a Spearman correlation on the change in accruals and change in cash flow from operations where both of these measures are scaled by lagged total assets. Based on Myers et al. (2007), an increase in the negative correlation between these values shows an increase in the degree that companies are smoothing earnings through accruals to conceal economic shocks.

3.2.3 Earnings Discretion Measure: Magnitude of Accruals

The third and fourth measures focus on earnings discretion measure. Managers also misstate the firm performance earnings in order to reach firm earnings targets or analyst expectations. One way of determining the degree of discretion used by managers is by examining the magnitude of accruals. Therefore, we analyze the state's median value of accruals scaled by the absolute value of cash flow from operations. The scaling is done for control on firm size and firm performance. The higher the value implies a higher degree of discretionary accrual management by managers.

3.2.4 Earnings Discretion Measure: Small Loss Avoidance

Apart from reaching earnings targets or analyst estimates, managers can misstate earnings in order to avoid small losses. So, if a firm performance is slightly below the zero mark, managers can manipulate earnings to bring total income slightly above zero so they can avoid showing a negative value on the financial statements. Therefore, we calculate the number of firms per state that show a small profit and divide that number by the number of small losses for that state. The small losses and small profits are calculated by scaling net earnings with lagged total assets. If the amount is between [-0.01, 0), then the firm is considered to have reported a small loss. If the amount is between (0, 0.01], then the firm is considered to have reported a small profit. The higher the value of this ratio shows a higher degree of discretionary accrual management by firms in each state.

4. Results

After all the data has been obtained by COMPUSTAT, we use STATA/SE 13.1 to measure the degree to which firms have been involved in four different types of discretionary accrual management. As explained above, this study is based in the work of Leuz et al (2003). This study uses the same technique to determine the coefficients for all four measures within the United States in order to examine the impact of the different legal systems. This is done so that we can shed light to the question whether firms in Louisiana, being governed primarily by French civil law, do indeed involve in discretionary accrual management due to weaker investor protection. Table 2 summarizes all the main results calculated from the 28 states of the U.S. used in this study. The four measures are listed as EM1, EM2, EM3 and EM4.

Table 2: State Scores for Earnings Management Measures

U.S. State	EM1 σ(OpInc)/ σ(CFO)	EM2 ρ(ΔAcc, ΔCFO)	EM3 |Acc|/|CFO|	EM4 No. of S. Profit/ No. of S. Loss
California	0.7565470	-0.7306	0.4532569	1.156
Colorado	0.7842459	-0.6596	0.3770219	1.800
Connecticut	0.8121110	-0.7352	0.2628961	0.750
Florida	0.7363325	-0.6877	0.4121697	1.500
Georgia	0.6446320	-0.7749	0.3034085	3.000
Illinois	0.6844659	-0.7642	0.2985239	4.800
Indiana	0.7457268	-0.7991	0.2930618	2.714
Kansas	0.6530152	-0.7176	0.3592294	1.333
Louisiana	0.6029210	-0.7453	0.3187070	2.333
Massachusetts	0.7714674	-0.7155	0.3581111	2.000
Maryland	0.7270345	-0.7252	0.3098814	2.600
Michigan	0.8469171	-0.6750	0.3406057	1.125
Minnesota	0.7124395	-0.7006	0.4104047	1.190
Missouri	0.8071129	-0.6936	0.2256804	1.400
North Carolina	0.7721741	-0.7753	0.3174502	1.700
New Jersey	0.7372638	-0.7218	0.3132215	1.400
Nevada	0.8428620	-0.5484	0.4462764	1.625
New York	0.8329831	-0.7320	0.4101819	2.227
Ohio	0.7533774	-0.7967	0.2955498	1.778
Oklahoma	0.7213212	-0.7489	0.3691269	3.000
Oregon	0.6640114	-0.7942	0.4023791	2.800
Pennsylvania	0.7704996	-0.7574	0.2855475	1.650
Tennessee	0.8025162	-0.7692	0.2869405	4.000
Texas	0.7439265	-0.6879	0.3803147	1.700
Utah	0.6811796	-0.6682	0.3821476	0.667
Virginia	0.6970606	-0.8389	0.3004405	1.667
Washington	0.6943735	-0.7762	0.3867508	3.000
Wisconsin	0.7880753	-0.8031	0.2948111	1.125

The first measure examined earnings smoothing in order to conceal changes in economic performance. With this measurement, the lower the score, the higher the degree to which a firm engages in earnings management. The range of scores for this particular measure is from 0.603 to 0.847. Out of the 28 states included in this study, we notice that Louisiana has indeed the lowest score of 0.603. Based on Leuz et al (2003), who found that weaker outside investor protection rights are related to higher degrees of earnings management, such a low score shows that Louisiana, a French civil law based state, does indeed show higher degree of earnings smoothing.

As for the second measure, which focuses on concealing economic shocks to firm's operating cash flow, the score range of the Spearman correlation is from -0.5484 to -0.8389. In this measure, Louisiana, with a score of -0.7453 is somewhere in the middle, although it is closer to the bottom. However, for this measure we cannot make a distinction in terms of effects by the legal system.

The third measure focuses on the discretionary accrual management for the purpose of misstating the financial performance to reach certain targets. This can be determined by using accruals as the proxy for the degree of this type of earnings management. We examine the magnitude of accruals, and the scores range from 0.225 to 0.453. Similar to the results for the second measure, the score of 0.319 for Louisiana falls again somewhere in the middle. Again, for this type of measure, we cannot make a distinction between the two legal systems when it comes to earnings management.

The fourth and final measure examines the degree of earnings management by firms for the purpose of avoiding small losses. By dividing the total number of small profits with the total number of small losses for each state, we obtain results with a range of scores from 4.8 to 0.667. Louisiana in this list was 10th with a score of 2.333. Therefore, it is difficult to make any distinctions based on the different legal systems.

5. Conclusion

Previous studies focusing on the difference between legal systems and their relationship with earnings management has shown interesting results. La Porta et al. (1998) studied how different legal systems affect investor protection, while Leuz et al. (2003) extended this study by examining the degree of earnings management on a country level based on the degree of strength of outside investor protection. Our paper extends even more the knowledge of the relationship between legal systems, investor protection and earnings management by testing the results within the United States.

As detailed in previous sections of this paper, Louisiana's legal system is based on the French civil law, and it is the only state in the U.S. to have such a legal system. The remaining 49 countries are based on the common law. Since the French civil law was linked to weak investor protection as well as to a higher degree of earnings management, we compared four different ways of measuring accrual earnings management throughout 28 U.S. states including Louisiana. Out of the four measures, only one showed a clear distinction between earnings management in Louisiana and in other states. This measure focused on the degree to which managers would reduce the variability of reported earnings by altering accruals, which was calculated as the median ratio of the standard deviation of operating earnings divided by the standard deviation of cash flow from operations. Louisiana had the lowest score with the second lowest score being 0.05 points higher, which is high considering the highest score was only 0.85. The other variations of measuring earnings management seemed to show no distinction.

6. Limitations and Areas for Future Research

Several factors might have affected the results to this study. First of all, we should keep in mind that Louisiana is not entirely based on the French civil law, and it is indeed mixed with the common law. Therefore, Louisiana might be influenced by certain aspects of the common law when it comes to investor protection and earnings management. Future research could focus on all the differences and similarities of the two systems that might be affecting the various accrual earnings management measures presented in this study. Also, the different accounting systems might play a role in such differences. Another factor that might have affected the results is the sample size. Previous studies recommended at least 300 firm-year observation per country. On a state level it was much more difficult to obtain that many firm-year observations for several states, and therefore we lowered the minimum firm-year observations to 150, which was very close the available firm-year observations in Louisiana. Another area of interest related to this topic is the degree of earnings management by firms in Quebec, Canada, which is similar to the status of Louisiana in the U.S. as it is also governed by the French civil law. The topic of earnings management is quite intriguing and requires further attention by future researchers.

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