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Corporate accruals quality during the 2008–2010 Global Financial Crisis☆

Neal Arthur[a], Qingliang Tang[b], Zhiwei (Stanley) Lin[c,*]

[a] School of Business, The University of Sydney, Sydney, Australia
[b] School of Business, Western Sydney University, Sydney, Australia
[c] College of Economics, Shenzhen University, 3688 Nan Hai Street, Nanshan District, Shenzhen 518060, Guangdong, China

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ABSTRACT

This study investigates the earnings quality (measured by accruals quality) of European firms during the 2008–2010 financial crisis. Prior literature suggests that the quality of earnings would be low during the crisis. However, we found that the accounting standards-setting bodies and regulators of the capital market showed great concern regarding financial reporting policy, so we expected that there would be strong incentives for firms to improve earnings quality during an economic recession. In the present study, we compare the earnings quality of sample firms in 14 European countries during the 2005–2007 period and during the financial crisis period (2008–2010) and find that the sample firms tended to present higher-quality financial reports during the financial crisis than prior to it. This finding suggests that reduced investor confidence and market liquidity engendered by the financial crisis motivated management to strategically enhance earnings quality in an attempt to increase investor confidence and reduce the negative impact of the economic recession. Our results are robust after taking into account other firm- and country-level factors that may affect earnings management incentives and behavior.

Introduction

The global financial crisis, which began in September 2008, severely shook investor confidence, affected corporate earnings and stock market performance, and caused the failure of many firms. There has been passionate debate regarding the role of accounting in the crisis. This debate concerns whether the accounting system, which used fair value measurement, decreased or increased investor confidence and thus either mitigated or exacerbated the crisis (Lin, Morris, Kang, & Tang, 2013). This debate is based on the assumption that investors are concerned about the quality of financial reporting and use financial reporting information to make decisions. If this is true, another question arises: would management strategically adjust their accruals strategy to manage investor confidence during a financial crisis?

The extant literature indicates that the financial crisis was a crisis in investor confidence; investors were panicking and eager to sell shares (Okonjo-Iweala, Kwakwa, Beckwith, & Ahmed, 1999; Statman, 1999). User confidence was crucial, and

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* Corresponding author. Tel.: +86 18676784375.
E-mail addresses: neal.arthur@sydney.edu.au (N. Arthur), q.tang@westernsydney.edu.au (Q. Tang), stanleylin@szu.edu.cn (Z. Lin).

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management was aware that financial reporting would affect users' perceptions of a firm's financial condition and operating performance. Would these factors give strong incentives for firms to manage earnings to enhance investor confidence? This question is important, because an understanding of corporate accruals strategy, behavior, and incentives during the crisis will help identify robust accounting practices and systems that better accommodate the needs of users and firms that struggle to survive periodically occurring financial downturns. This debate motivates the current study. Our evidence is likely to be relevant for accounting standard-setting bodies around the world(for example, the IASB and the FASB), which are considering the impact of accounting on the financial crisis so that accounting standards, such as fair value standards particularly, might be revised appropriately.

Firms tend to adjust their operating strategy when facing pressure to survive a crisis, and financial reporting policy is integral to a firm's overall business strategy. Our research question is: in response to the economic recession, did firms adjust their financial reporting policy to boost accounting performance? On the one hand, accounting performance was likely to be poor. Consequently, firms had a stronger incentive to use less conservative accounting methods and engage in more aggressive earnings management, so that they could show a more positive picture to investors. It is also possible that managers of firms that suffered a loss would be willing to "take a bath" to report a bigger loss. If this argument is true, we would observe lower earnings quality during the financial crisis.

Investor confidence was lower during the financial crisis, causing illiquidity in the share market (Hameed, Kang, & Viswanathan, 2010). Investor confidence was so crucial that governments around the world spent hundreds of billions of dollars to stabilize markets and restore investor confidence. Similarly, firms spared no effort in their attempts to maintain investor confidence. The literature provides evidence that financial reports affect investor decision-making (Ball & Brown, 1968; Beaver, 1968). Given that the quality of financial reporting is associated with investor confidence and the priority of management during the financial crisis was to increase confidence, we expect that managers might adopt a more transparent financial reporting strategy to restore investor confidence and improve liquidity. Thus, we would observe higher quality financial reporting during the financial crisis.

The present research looks for evidence that would be useful for an understanding of firms' financial reporting policy, strategy, and quality. Following previous studies, we use the magnitude of discretionary accruals (measured using the modified Jones model and the performance-controlled modified Jones model) as a proxy for the degree of transparency (quality) of financial reporting. Our sample includes the financial statements of listed European (EU) firms from 2005 to 2010. Our results show that EU firms, on average, engaged in less earnings management and presented higher quality accounting information during the financial crisis period than during the pre-crisis period. The evidence suggests that management had a strong incentive to increase investor confidence during the financial crisis by providing reliable financial statements that would reduce information asymmetry and improve market liquidity so as to mitigate the negative impact of the economic recession. Our results remain robust when we control for factors that affect firms' earnings management incentives (including firm size, leverage, and profitability, etc.).

This study makes a number of contributions to the literature. First, most of the previous research on financial reporting during the financial crisis explored the impact of fair value measures on the valuation of firm equity (e.g., Lin et al., 2013). The debate on fair value accounting has appeared to ignore the role of managerial incentives. In contrast, the current study examines the financial reporting strategy of management in maintaining investor confidence. Our findings complement prior studies by showing that managerial incentives play an important role in mitigating the negative effects of the crisis. Second, we found limited published research on the impact of the financial crisis on earnings quality and most were conducted in a domestic setting[1]. Our investigation in an international context is more comprehensive. The purpose of our multinational research design is to reflect the global nature of the crisis. Thus, our findings contrast with those using a national setting and provide more insight into the relationship between economic conditions and financial reporting. Third, most previous research on earnings management incentives was conducted during normal economic conditions and under the assumption of "business as usual[2]". However, during an economic downturn, the assumption of "business as usual" does not hold. We therefore examine financial reporting strategy in a unique business environment and find that management adjusted earnings strategy in response to the changed economic environment. This issue was not considered in previous studies, and the results are potentially useful to predict managerial behavior during future periodic economic recessions.

The remainder of the paper is organized as follows. Section 2 develops the hypotheses, and Section 3 discusses the research methodology. Section 4 presents the empirical results, and the final section offers some conclusions.

Literature review and hypothesis development

Literature review

Prior literature suggests that earnings management is intended to alter the perception of users by overstating (or understating) a firm's earnings (Healy & Wahlen, 1999). Earnings management reduces the quality of financial reporting

[1] See next session on literature review for studies on financial crisis and earnings management.

[2] Most of the research on earnings management was done in the context of normal economic conditions, rather than during a period of financial depression (e.g., Yoon and Miller, 2002; Teoh, Welch, & Wong, 1998a; Leuz et al., 2003).