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Financial crisis, GDP variation and earnings management in Europe

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ABSTRACT

The purpose of this study is to examine the consequences of the financial crisis on the European companies' in conjunction with earnings management practice. It focuses on financially distressed companies that audited by a big 4 auditor during recession years. The study makes use of discretionary accruals as a proxy for earnings management and studies the influence of big 4 auditor, in order to shed more light on possible causes for shifting earnings. The findings of the study provide evidence that financially distressed companies that audited by a big 4 auditor exhibit lower discretionary accruals. The results reveal that Greek and Spanish companies reduce earnings management manipulation during recession. In contrast, Portuguese, Irish and Italian companies show mixed results. They tend to reduce earnings management practices, but there are reasons that influence managers' behavior to increase earnings management. The findings of this study can be useful for both investors and standard setting authorities.

1. Introduction

The global financial crisis affected the economic environment and, consequently, had an important impact on the companies' results and financial situation. Eurozone crisis caused financial difficulties

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for many European companies and a number of them was directed to bankruptcy. The aim of the study is to investigate how financial crisis affects financially distressed companies and the scope for earnings manipulation. In other words, we use discretionary accruals as a proxy for earnings management and we study if the managers tend to use earning management techniques. We suppose that managers are influenced in negative growth periods to use earnings management techniques as to prevent bankruptcy.

It is undeniable that financial crises provoke large changes in economic environment. The decline in GDP is the more important characteristic of an economy in financial crisis, so that a financial crisis is determined by a recession as it is represented by a decline in GDP. As a result, for economies suffering a financial crisis we can observe reduction in production, lack of liquidity and an increase in the number of bankruptcies. Furthermore, companies operating in an environment characterized by recession try to survive by cost cutting measures, by reducing their losses and also by presenting an enhanced financial position. Many researchers examine the impact of financial crises in various aspects. Treepongkaruna and Wu (2012) examine nine countries in Asia Pacific region from 1997 to 2001 and they find that the rating announcement had asymmetric impacts on stock and currency market during financial crises. Additionally, Nikkinen et al. (2012) investigate the stock market returns between developing and emerging stock markets during financial crisis of 2008–2009, concluding that market integration has increased during recession. Furthermore Mac an Bhaird (2013) studies the companies' characteristics, which apply for external finance before and after recession, concluding that financially distressed companies suffer more from financial crisis.

In a recent study, Iatridis and Dimitras (2013), examined earnings manipulation, value relevance during the financial crisis, defining the start of the crisis as a single time point. Despite the fact that the 2008 year is considered as the beginning of worldwide crisis, there is no clear indication when the crisis started for each country. In the case of the European financial crisis we observe that different countries face GDP fluctuations, but not simultaneously at the same time for all the countries. Therefore, our dilemma was about the time that each country entered the crisis. GDP change is a welfare, progress indicator, there are various studies that make use of GDP growth as an indicator of the recession. Rose and Spiegel (2011) in a study exploring the causes, consequences of the crisis, using GDP change as an indicator for the crisis among others variables. Additionally, Frankel and Saravelos (2012) in their study examine whether important indicators such as GDP change can help explain the incidence of 2008–2009 financial crisis among various countries. Furthermore, according to the specific characteristics of the EU countries the presence of the crisis in each country is associated with a GDP decline. Therefore, we use the decline of GDP macroeconomic variable as a proxy for financial crisis in EU countries, we study the behavior of the companies during recession years.

The study is focused on the five European countries that were most affected by the recession in the years 2008–2011 namely Portugal, Ireland, Italy, Greece, Spain. In other words, these countries with weak financial sustainability, is easier for someone to observe the consequences of the financial crisis

Moreover, there are many studies concluding that managers of financially distressed companies manipulate financial reports to conceal the financial problems. DeAngelo et al. (1994) conclude that companies with financial problems have large negative accruals in the years before bankruptcy. On the other hand, DeFond and Jiambalvo (1994) as well as Rosner (2003) show that distress companies' managers decrease earnings in order to obtain a qualified opinion from the auditors. This study is based on Iatridis and Dimitras (2013), who studied earnings manipulation and value relevance before and during the European debt crisis using alternately 2008 and 2009 as the cut-off points for distinguishing the period before the crisis and the crisis period. In contrast, we use the growth of GDP as the indicator variable for determining the crisis period. Furthermore, we examine the relation between the role of big 4 auditor and earnings management in financially distress companies. Finally, we study the role of value relevance in financially distressed companies that are audited by a big 4 auditor.

The results show that financially distressed companies exhibit lower discretionary accruals during recession. Especially, Greek and Spanish companies reduce earnings management manipulation during recession. In contrast, Portuguese, Irish and Italian companies show mixed results. They tend to reduce earnings management practices, but at the same time there are situations that they behave differently and they display stronger scope for earnings manipulation. The main contributions of this study can be summarized in that first, we examine how the presence of financial crisis affects the use