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ARTICLE

Audit and earnings management in Spanish SMEs[☆,☆☆]

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Abstract Evidence about the relation between earnings management and voluntary audits is scarce, and there is no research about the effectiveness of mandatory audits to improve earnings quality. Using a sample of Spanish SMEs, where some companies are mandatorily audited and some are exempt from audit, we examine if audits, either mandatory or voluntary, help to improve accounting quality by constraining earnings management. We also examine differences between voluntary and mandatory audits, as well as the role of Big 4 and Middle-Tier auditors. After controlling for other characteristics that affect earnings management, we find that audited companies have lower absolute discretionary accruals, but do not find significant differences among auditors. Voluntary audits also restrain earnings management, but in a lesser extent than mandatory audits. When we use signed accruals, audits are only effective against income-increasing behaviours, what is explained by the auditor conservatism. Additional analyses support the results obtained.

Introduction

Literature about earnings management and accounting quality is extensive (García Osma et al., 2005; Dechow et al., 2010). A stream of research that has been deeply studied is the relationship between auditing and earnings management, because it is expected that audits work as a constraint to managerial discretion in reporting earnings and help to improve the reliability and the quality of the financial information. The papers that have studied this relationship have focused on the differential value among auditors to deter earnings management activities, depending on specific dimensions of auditors. However, there is a lack of empirical research in two issues: (i) whether audits,

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regardless of the characteristics of the auditor, actually constrain earnings management and improve earnings quality; and (ii) whether there are differences between voluntary and mandatory audits.

First, papers commonly examine the differences between auditors with different characteristics (Becker et al., 1998; Balsam et al., 2003; Chung et al., 2005; Carey and Simnett, 2006; Cano, 2007; Basioudis et al., 2008). However, they do not study if audits, regardless the auditors' characteristics, have a differential value compared to the non-audit case. The fact that most of the literature examines settings where audits are mandatory, such as large private or listed companies, involves that these papers cannot value the differences between unaudited and audited companies. Secondly, the few papers that study audits per se generally show that audited companies have a lower cost of debt than the unaudited ones (Kim et al., 2011; Minnis, 2011), so audited financial statements are *perceived* to be more reliable and thus seem to provide higher quality information. However, with the exceptions of Minnis (2011), Ojala et al. (2011) and Dedman and Kausar (2012), there is a lack of empirical evidence examining whether the audited companies *actually* provide higher quality information.

Minnis (2011) and Dedman and Kausar (2012) examine the effects of voluntary audits on accounting quality, but there is no research about the effects of mandatory audits. This is important because accounting quality can be affected in a different way depending on whether audits are voluntary or mandatory. On the one hand, voluntarily audited companies may be willing to send a signal about the quality of the accounting information, and Minnis (2011) and Dedman and Kausar (2012) show that audits improve accounting quality. However, we can expect a ''label'' effect for the voluntary audit, i.e. companies only choose to be audited to increase their *perceived* accounting quality (Daske et al., 2013; Koren et al., 2014). On the other hand, mandatory audits are assumed to ensure a minimum quality of the financial information (Ruiz and Gómez, 2008), thus companies that shun the audit requirement would have lower accounting quality. If these differences are not observed, mandatory audits would fail to achieve their basic aim.

SMEs are a natural setting to test the effect of audits on accounting quality. First at all, it is worth noting their relevance in the economy in both the EU and the US (Allee and Yohn, 2009; Wymenga et al., 2012). In Spain, this importance is even higher (EC, 2012). Secondly, the SMEs setting allows us compare audited and unaudited firms, a comparison that is not possible among public and big private companies because all of them are mandatorily audited. Moreover, although there are papers that analyze the relation between audit quality and earnings management in the private setting (Cano, 2007; Van Tendeloo and Vanstraelen, 2008), the value of audits for the smaller of them, however, is not as obvious, because their stakeholders may rely more in alternative information sources (Berger and Udell, 2006; Gill de Albornoz and Illueca, 2007), so the role of auditors may be partially different.

The Spanish case may shed light to this limited value, because of the lower tradition in the use of accounting information compared to common-law countries with a longer history of auditing, such as the UK and the USA. Moreover, similar to most EU countries, Spain requires audits for companies that exceed a certain size. The Spanish Statutory Audit Thresholds (SAT) are lower than those generally applied in the EU, so we can test if audits have a different effect depending on their character (voluntary or mandatory) in a relatively homogeneous sample, i.e. in a sample that only includes small and medium companies.

Furthermore, because of the more limited usefulness of financial information for SMEs, mandatory audits are often considered a potential source of administrative burdens, so the EC is considering the possibility of revising the requirement for mandatory audits for these companies (EC, 2010). Finally, the audit market for SMEs also gives us the opportunity to test the role of Middle-Tier auditors (Boone et al., 2010; Sundgren and Svanström, 2013).

Therefore, using a sample of Spanish SMEs, we examine if audits are a deterrent to earnings management, measured through the signed and absolute values of discretionary accruals, and test whether this effect is driven by a real commitment with accounting quality among voluntarily audited companies, or with a minimum accounting quality ensured by mandatory audits. We also test differences between voluntary and mandatory audits. Moreover, we examine if audit quality, proxied by a three-level classification (Big 4, Middle-Tier and small auditors), means differences on the level of earnings management. Since papers about audit choice have serious endogeneity problems, we use a fixed-effects approach instead of OLS estimations to partially mitigate them (Kim et al., 2011; Lennox et al., 2012)

We find that audited companies have a lower level of absolute discretionary accruals than the non-audited ones; voluntary audits also restrain earnings management, but in a lesser extent than mandatory audits. These results suggest that although both mandatory and voluntary audits improve earnings quality by restricting the magnitude of accruals, the lower visibility and litigation risks faced by auditors in the voluntary setting encourage them to be less restrictive. When we examine separately the signed discretionary accruals, we do not find a significant effect of audits on negative accruals, what may be due to the auditor conservatism, for which auditors are not effective against earnings management behaviours when companies have incentives to manage downward. On the other hand, we do not find that significant differences for companies audited by Big 4 and Middle-Tier auditors. Additional analyses support the results obtained.

The paper contributes to the literature about auditing and the quality of financial information in the following ways: first at all, it extends literature about the audit/non-audit discussion. Although previous papers have studied if auditors, playing an *information role*, help to improve the credibility of the financial statements, there is a lack of empirical evidence examining whether the audited financial information is actually of higher quality. As far as we know, only Minnis (2011), Ojala et al. (2011) and Dedman and Kausar (2012) have examined the effect of voluntary audits on accounting quality. We complement these studies by examining this association in a code-law country, and by considering also both the effect of mandatory audits and