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Terrorist attacks and company financial numbers: Evidence on earnings management and value relevance from Madrid, London and Istanbul

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ABSTRACT

This study focuses on three major terrorist attacks that took place in Madrid on 11 March 2004, in London on 7 July 2005, and in Istanbul on 27 July 2008. It examines firms that belong to banking, insurance and leisure sectors and assesses the earnings management potential and the value relevance of reported financial numbers before and after the terrorist attack. The study shows that, in general, a terrorist attack is likely to increase the scope for earnings management and reduce the value relevance of reported financial numbers. The terrorist attacks in Madrid and Istanbul have led to higher earnings management potential and less value relevant financial numbers. In contrast, the UK terrorist attack has not increased the potential for earnings management, while the value relevance of reported financial numbers has increased. The findings indicate that the insurance industry and the leisure industry are more inclined to use earnings management after the attacks. Comparing the common-law and code-law countries after the attack, the study shows that the UK displays lower discretionary accruals and higher value relevance of reported financial numbers. It is noteworthy that, after the attacks, the UK exhibits higher profitability, leverage and liquidity compared to Spain and Turkey.

1. Introduction

On 11 March 2004, three bombs exploded on the train entering the Atocha Railway Station of Madrid. Almost simultaneously, other four detonations followed in the first, fourth and sixth carriages

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of the second train, about 500 m outside the station. Altogether, ten bombs on four trains in three different stations were exploded, while 191 people lost their lives and 2050 were injured. According to the Institute of Analysis Finance, it is estimated that the compensation that was reimbursed amounted to €134.12 m. The sector that was affected mostly was the Spanish travel agencies and transportation companies. Jose Luis Zoreda from Exceltur, a major Spanish travel company, reported a negative effect on sales by 34.4%. The impact was less intense in the long-distance tourists. For example, only a 9% fall in sales was reported for the Mediterranean coast and the Canary Islands, which constitute almost 50% of the total international tourist market in Spain every year. In contrast, in the area of Madrid, 82% of companies suffered a fall in sales, in some cases being more than 30%. From 34.4% of the companies which were affected from the attack, 48.5% of them had recovered by April, 8. For many listed companies, it took about a month and a half after March, 11 to recover their share prices. Likewise, the Spanish economy managed to recover quite soon.

In London, on 7 July 2005, three bombs exploded on the train travelling from King's Cross to Russell Square, on the train travelling from Liverpool Street to Aldgate and on the train travelling from Edgware Road to Paddington. Almost 1 h later a fourth bomb exploded on a double-decker bus. The attack caused the death of 56 people and the injuring of about 700. This terrorist attack was the deadliest attack in the UK since the 1988 bombing of Pan Am Flight 103 at Lockerbie, which killed 270 people. The exchange rate between the British pound and the US dollar went down by 89 pence. The FTSE 100 Index decreased by 200 points 2 h after the attack, which was the greatest decrease in the London Stock Exchange after the period of the war in Iraq. The immediate reaction of the British Stock Exchange supervisory authorities limited losses to 71.3 points (1.36%) down from the previous day. Insurance companies raised their premiums, raising the levels of security expenditure. Major tourist destinations in central London suffered a reduction of 15% in visits. The resulting fall in tourism cost more than £300 million. However, business reports showed that the shock for the sectors of tourism and insurance was not as serious as predicted.

In Istanbul, on 27 July 2008, two explosions convulsed a busy shopping street in the Güngören district of Istanbul, which is located on the European bank of the city. The bombing caused the death of 17 people and the injuring of 154. The first bomb was placed in a telephone booth and the second bomb in a waste container 50 m away. Drakos and Kutan (2003) explain that the terrorist activity in Turkey may be regarded as a constant, implying that the stock market may have incorporated this inherent attribute in stock pricing. However, the extent of this incorporation in stock prices and published financial information would depend on the size and magnitude of a terrorist event as well as on the deviation between actual stock prices and intrinsic values and market efficiency levels (see Yalcin, 2010; Graham and Ramiah, 2012). For example, Christofis et al. (2010) have shown that the effects of the 1999 and 2003 terrorist attacks were severe for the Istanbul stock market. In particular, they have found that the 1999 bombing has negatively affected all indices except from banks, trade and industrial. It is noteworthy that, on the event day, the tourism sector displayed a decline by 8.79% as well as significant negative cumulative abnormal returns over a 3-day and 11-day window. Likewise, on the event day of the 2003 bombing, the main Istanbul stock market index declined by 7.4%, while the banking and tourism sectors exhibited a decline by 11% and rebounded after 15 trading days. Considering the terrorist activity in Turkey as a constant would imply that the impact caused by a terrorist attack may endure for a longer period, causing revenue losses on a more permanent basis. Although the Istanbul stock market did not experience a significant negative impact from the 2008 bombing (Christofis et al., 2010), this terrorist attack did cause significant turbulence in the country (Yaya, 2009).

The direct costs that arise from the immediate consequences of a terrorist attack involve loss of property, increasing measures of security, etc. The indirect costs cause damage in productive activities, e.g. tourism, insurance, savings and consumption, transportation, investor decisions, business (Saxton, 2002; Abadie and Gardeazabal, 2008). A terrorist attack may also affect uncertainty and investment, international trade, and stock market expectations, leading to higher required rates of return as a compensation for bearing higher risks. The indirect costs may also include the provision of financial aid to the injured or to the relatives of the victims for example in the form of pension, the costs of re-planning the growth strategy for the tourist sector, the re-routing of investments, and the reduction of economic growth (Frey, 2009). It should be noted that the sensation of a permanent threat has its own long-term economic effects.