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Audit opinion and earnings management: Evidence from Greece

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ABSTRACT

This study examines the relationship between audit opinions and earnings management, as measured by discretionary accruals, for listed firms on the Athens Stock Exchange (ASE). We divide the qualified audit opinions into two categories: qualified for the going-concern uncertainty and qualified for other reasons. The results indicate that audit opinions are not related to earnings management. Client financial characteristics, such as profitability and size are determinants of the going-concern audit opinion decision. The decision of auditors to issue qualified opinions for other reasons is explained by the type of audit opinion issued in the previous year.

1. Introduction

In recent years, Greece has experienced the effects of three major financial events that are worth investigating in the context of financial and auditor reporting. These events are the implementation of International Financial Reporting Standards (IFRS) on publicly listed firms beginning on January 1, 2005, the global financial crisis that began in the US in 2007 and officially ended in 2009 and, most importantly, the Greek debt crisis.

The first signs of the European sovereign debt crisis became visible in Greece in 2009. Pre-existing conditions, such as the engagement of the government in substantial foreign borrowing and domestic overspending, the successive downgrading of government debt, the failure to implement consistent economic and structural reforms and the deterioration of macro-economic indicators, undermined the ability of the country to prevent the shocks associated with the crisis. While Greece has received consecutive packages of rescue loans from the trilateral mechanism of financial support – the European Union (EU), the International Monetary Fund (IMF) and the European Central Bank (ECB) – these rescue loans have been conditional on the implementation of austerity measures and the restructuring of the Greek national debt.

Inevitably, financial crises have a direct effect on the business world. For example, liquidity and credit problems are intensified, and the threat of bankruptcy is even more pronounced. In turn, these threats have an impact on a number of parties related to affected firms. The economic and social costs of corporate failures are substantial to the suppliers of capital, that is, the investors and creditors, who may lose their investments, as well as to the management and employees, who may lose their jobs (Charitou, Lambertides, & Trigeorgis, 2007). In such a setting, there is a growing concern about the quality of the information provided in financial statements by managers, especially of financially distressed firms because their incentives to manage earnings are potentially magnified. At the same time, concerns over auditor reporting increase.

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Although auditors have incentives to remain independent,[2] their willingness to report accounting deficiencies may lessen during crises. Auditors respond to incentives; when legal, regulatory or economic conditions are more tolerant for auditors, they are likely to issue less qualified opinions (Carson et al., 2012). Conversely, when there are changes that put the profession in the spotlight, the likelihood of issuing going-concern qualified opinions is higher (Carson et al., 2012).

Our aim is to investigate the association between auditor reporting, as measured by auditors' willingness to issue qualified opinions, and earnings management, as measured by discretionary accruals. The sample of the study consists of firms listed on the Athens Stock Exchange (ASE) for the post-IFRS period 2005–2011, a period incorporating the severe global and Greek economic downturn. First, we analyse the qualification types of all qualified audit opinions. Second, in the empirical investigation of our hypotheses, we divide the qualified opinions into two categories: qualified for the going-concern uncertainty and qualified for other reasons. Finally, we test our hypotheses in a subsample of distressed firms based on the probability of greater incentives to manage earnings.[3]

This topic is important because the current economic environment reopens fundamental questions about the role of auditors in maintaining financial statement users' confidence in the audit report. Therefore, it is vital to examine the association between audit opinion and earnings management in a situation where the propensity to manage earnings may be high. In addition, although audit qualifications and their determinants have been previously examined in the Greek context,[4] it is the first time that the qualification types are extensively analysed for the period 2005–2011 and that the going-concern uncertainty is separated from the other qualifications in an empirical investigation of the audit opinion decision.

Overall, the results indicate that audit opinions are not related to earnings management. The variability in the going-concern decision is explained by client financial characteristics, such as profitability and firm size, audit effort and audit opinion type issued in the previous year. The economic downturn has affected the financial condition of firms, which is depicted in the type of audit opinion they receive. Additionally, the qualified audit opinion, for reasons other than the going-concern uncertainty, is explained by the type of audit opinion issued in the previous year, both in the full and the distressed samples. Auditors do not consider client financial characteristics in their reporting decision, and prior year audit opinion is the only useful decision tool in predicting the current year's opinion.

The remainder of the study is organised as follows. Section 2 describes the Greek institutional setting of auditing. The literature review and hypotheses are presented in Section 3. Section 4 discusses the methodology, describes the sample, outlines the analysis of the audit opinion qualifications and presents the empirical model. Section 5 documents the results, while Section 6 presents the study's conclusions.

2. The institutional setting of auditing in Greece

Greece is a continental European country with many economic and socio-political distinctive features. During the last three decades, Greece has been influenced by neo-liberal, free-market forces, but Greek culture, politics and economics remain a mixture of Eastern and Western influences (Caramanis, 2005).[5] Business organisations have been traditionally family oriented (Spanos, Tsipouri, & Xanthakis, 2008) and stakeholder driven, with poor legal protection for investors. Banks are major providers of corporate capital, and they often develop personal relationships with the firms (Tzovas, 2006). In this relationship-based system, banks may arrive at their credit decisions based on information obtained directly from the owners of the firms, thereby undermining the importance of public accounting information (Tzovas, 2006). The significant expansion of the Athens Stock Exchange (ASE) in the late 1990s turned many firms from private-family owned businesses to publicly listed entities (Spanos, 2005), without changing the existing relatively high levels of family ownership concentration (Lazarides, 2010). In addition, the expansion of the ASE, followed by the crash of 2000–2001 and the requirements of international capital providers raised the need for effective corporate governance. However, Greek listed firms are still not entirely accustomed to the philosophy of modern corporate governance (Dimitropoulos & Asteriou, 2010), which further diminishes the quality of accounting information available to the public.

The Greek accounting setting is characterised as tax-driven and conservative (Ballas, 1994; Spathis & Georgakopoulou, 2007). As the corporate tax rate is perceived to be high, many firms attempt to avoid taxes using earnings management techniques (Baralexis, 2004). Furthermore, as financial statements are not the primary source of information for family concentrated firms, tax-reducing strategies may be implemented (Tzovas, 2006). With respect to the IFRS transition, Ballas, Skoutela, and Tzovas (2010) argue that it has increased reliability, transparency and comparability of financial statements. In contrast, the results of Karampinis and Hevas (2011) indicate that only minor improvements are evidenced in value

2 Competence and independence are used to describe audit quality (DeAngelo, 1981). Competence is the ability of the auditor to detect material error in the financial statements, and independence from the client firm is the willingness of the auditor to take a position that opposes the wishes of the client and report the material error (DeAngelo, 1981).

3 We extend the study of Tsipouridou and Spathis (2012) by reporting an in-depth analysis of the different types of audit opinion qualifications. While they consider an audit opinion dummy variable that takes on the value of 0 for an unqualified opinion and 1 for a qualified opinion, irrespective of the qualification type, we measure audit opinions in a more disaggregated fashion.

4 See for example Caramanis and Spathis (2006), Kirkos, Spathis, Nanopoulos, and Manolopoulos (2007), Koumanakos, Georgopoulos, and Siriopoulos (2008), Spathis (2003) and Spathis, Doumpos, and Zopounidis (2002, 2003).

5 In 1980, to facilitate membership to the EU, Greece adopted a general accounting plan closely based on the French Plan Comptable Général, which was amended in 1987 and 1990 in accordance with the 4th and 7th EU Directives, respectively (Ballas, 1994; Tsalavoutas & Evans, 2010).