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The International Journal of Accounting 49 (2014) 455 – 478

The International Journal of Accounting

Financial Crisis And Earnings Management: The European Evidence☆

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Received 28 March 2013
Available online 28 October 2014

Abstract

We examine the impact of the 2008–2009 financial crisis on the earnings management behavior of European-listed firms. We find that earnings management has significantly decreased in the crisis years. This trend is confirmed in most of the 16 countries under review. We also report a link between the level of earnings management and the economic growth rate and provide evidence suggesting that national characteristics and market forces affect the propensity of income smoothing but not accruals quality.

JEL Classification: G01 Financial Crises; M41 Accounting
Keywords: Financial crisis; Earnings management; Europe; IFRS; Investor protection; Accounting quality

1. Introduction

In recent years, earnings management has received considerable attention from academics, to the point that there is now an extensive body of research on the determinants and consequences of the manipulation of earnings. A common characteristic of these studies is that they do not take into consideration the macroeconomic environment of the firm. In other words, general economic conditions are held constant or supposed not to influence the incentives for earnings management. Nevertheless, it can be assumed that dramatic changes in the economic climate have an impact on the firm's propensity to

☆ We acknowledge with great appreciation the CPA Ontario for supporting *The Journal of International Accounting* Symposium held at Brock University on July 5–7, 2012. We appreciate the helpful comments and suggestions received during the Symposium and from conference participants at the 2012. AMIS conference (especially from Robert Faff).
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http://dx.doi.org/10.1016/j.intacc.2014.10.004
0020-7063/

manipulate earnings and/or the sign of these manipulations. The purpose of this paper is to explore the influence of significant variations in the economic environment by comparing the earnings management practices of European companies during the 2008–2009 financial crisis and in the years before.

According to the accounting literature, the motivations for earnings management can be classified into two categories: those relating to the market, and those resulting from agency relationships. Concerning the market influence, several studies provide evidence consistent with the intuition that firms manage earnings upward to avoid reporting losses, earnings declines, or negative earnings surprises (Ayers, Jiang, & Yeung, 2006; Burgstahler & Dichev, 1997; Degeorge, Patel, & Zeckhauser, 1999). Firms are also suspected of manipulating earnings to facilitate the success of security issues. This hypothesis is supported by several studies showing that firms tend to inflate their earnings prior to seasoned equity offerings (Rangan, 1998; Teoh, Welch, & Wong, 1998) or initial public offerings (Teoh, Wong, & Rao, 1998). Earnings management can also be used as a tool to influence the execution of contracts between the firm and its stakeholders. Empirical studies also provide evidence consistent with the idea that managers manipulate earnings to increase their earnings-based compensation (Guidry, Leone, & Rock, 1999; Holthausen, Larcker, & Sloan, 1995), or to avoid debt covenant violations (DeFond & Jiambalvo, 1994; Dichev & Skinner, 2002).

Prior studies investigate how firm's attributes (e.g., presence of bonus plans, earnings-based management compensation, or debt covenants) or a particular event (bond or equity issue) create incentives to manage earnings. Nevertheless, there is also evidence that macroeconomic conditions do affect earnings quality. Johnson (1999), for example, documents that the value relevance of accounting earnings is sensitive to the business cycle,

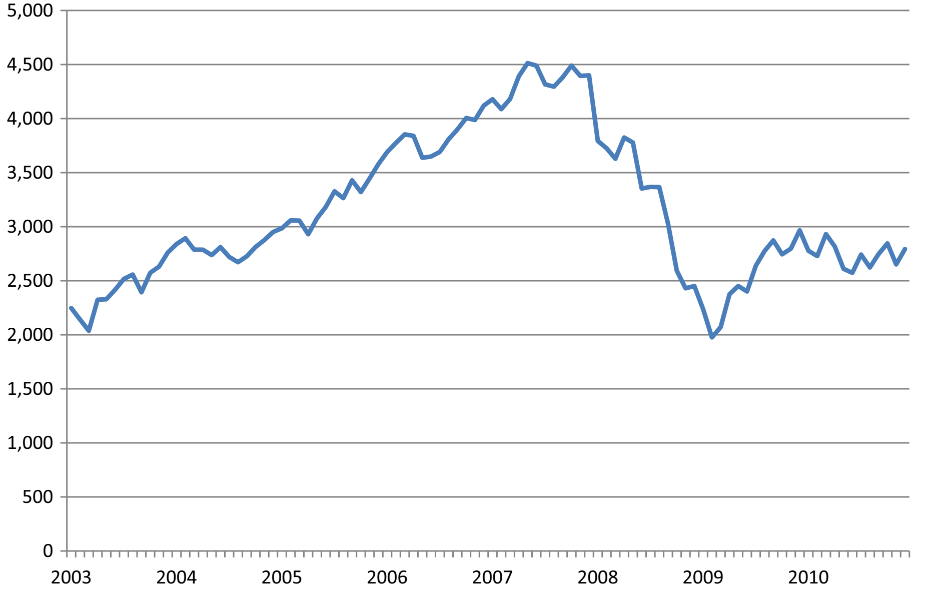

Fig. 1. Evolution of the EuroSTOXX50 index.