Int. Fin. Markets, Inst. and Money 41 (2016) 73–101

Contents lists available at ScienceDirect

Journal of International Financial Markets, Institutions & Money

journal homepage: www.elsevier.com/locate/intfin

Audit quality, investor protection and earnings management during the financial crisis of 2008: An international perspective

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ARTICLE INFO

Article history:
Received 27 October 2015
Accepted 23 December 2015
Available online 27 January 2016

Keywords:
Audit quality
Earnings quality
Investor protection
Financial crisis of 2008

ABSTRACT

This paper investigates the joint effect of global financial crisis of 2008 and investor protection on audit quality and the joint effect of audit quality and investor protection on earnings quality among three clusters based on the country classification of Leuz (2010. Acc. Bus. Res. 40 (3), 229). The results are mixed among clusters and research periods. First, the results show that all measures of audit quality are positively associated with most institutional factors of investor protection in all clusters. Second, audit quality is lower during financial crisis in all clusters and in most of audit quality measures. Third, audit quality is higher (lower) for firms with strong (weak) investor protection and legal enforcement during financial crisis in all clusters. Fourth, we report that earnings quality is stronger (weaker) in countries with strong (weak) investor protection in all clusters before and during the crisis. Fifth, higher (lower) audit quality implies higher (lower) earnings quality in all clusters, irrespective of the financial crisis. Finally, higher (lower) audit quality implies higher (lower) earnings quality in countries with high (low) investor protection in all clusters, irrespective of the financial crisis.

1. Introduction

Given the austerity of the global financial crisis of 2008, there have been few papers that examined its effects on the financial reporting in general. Specifically, the most representative results come from the paper of Persakis and Iatridis (2015) where the findings showed that during financial crisis, earnings quality is decreased. The effects were more severe in countries with medium and weak investor protection. However, it is surprisingly that there is no clearly evidence to its effects on the audit quality. More specifically, many economists have tried to pinpoint the role of auditors during the financial crisis of 2008 due to reduce information asymmetry (Knechel and Willekens, 2006). Other papers illustrated the effects of different aspects of audit quality on audit risk which in turn implies an increase of audit quality in periods of financial downturns. For instance, Bell et al. (2001) and Hogan and Wilkins (2008) found that there is a positive relationship between audit fees and audit risk. Hudaib and Cooke (2005) and Lin and Liu (2010) indicated that higher business risk leads to higher auditor turnover.

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http://dx.doi.org/10.1016/j.intfin.2015.12.006
1042-4431/

Considerably, the role of auditing in influencing earnings management during the global financial crisis of 2008 is lacking except from the findings of Iatridis and Dimitras (2013) who found that firms that are audited by a Big 4 auditor are likely to exhibit lower discretionary accruals and higher value relevance irrespective of the crisis period. In the same vein, Johl et al. (2007) and Chia et al. (2011) showed that Big auditors firms are able to significantly constrain the earnings management.

Further, recent researches suggested that strong investor protection, strong legal enforcement, and a common law legal system are a vital determinants of a high quality financial statement numbers and high audit quality. Based on the finding of Guenther and Young (2000), Bushman and Smith (2001), Leuz et al. (2003), Shen and Chih (2005), Burgstahler et al. (2006), Nabar and Boonlert-U-Thai (2007), Cahan et al. (2008) and Houque et al. (2012) earnings quality is higher in countries with strong investor protection and legal enforcement regimes. Similarly, the results from Newman et al. (2005) and Jaggi and Low (2011) confirmed their expectations that higher investor protection is associated with higher audit quality.

Consequently, this paper makes several contributions to the current literature. First, we analyze the joint effect of financial crisis of 2008 and investor protection on audit quality. In detail, based on the results of Choi et al. (2008) and Leuz et al. (2003), we except that audit quality is positively associated with investor protection. Further, based on the findings of Houston et al. (1999), Be'dard and Johnstone (2004), Hudaib and Cooke (2005), Lin and Liu (2010), Xu et al. (2011) and Aldamen et al. (2012), we expect that audit quality is higher during financial crisis. Consequently, in accordance of the findings of previous expectations, we expect that audit quality is higher in firms with strong investor protection and legal enforcement during financial crisis. Second, we analyze the joint effect of investor protection and audit quality on earnings quality in pre and crisis period. Particularly, based on the findings of Nabar and Boonlert-U-Thai (2007), Cahan et al. (2008), Houque et al. (2012) and Belghitar and Clark (2015), we expect that there is significant positive association between earnings quality and investor protection, irrespective of the financial crisis. Correspondingly, based on the results of Becker et al. (1998), Francis et al. (1999), Balsam et al. (2003) and Caramanis and Lennox (2008), we expect that there is significant positive association between earnings quality and audit quality, irrespective of the financial crisis. Again, in accordance of the findings of previous expectations, we expect that the joint effect of investor protection and audit quality is positively associated with earnings quality, irrespective of the financial crisis.

In addition, the use of a large sample of firm year observations from 18 largest economies worldwide, for the years 2005–2012, add to results reliability and authenticity, since we investigate the 55% of global market capitalization. Finally, it is trustworthy to mention that, it is the first study that investigate the hypotheses dividing the sample into three clusters as per level investor protection based on country classification of Leuz (2010).

The findings of the study are ambiguous. Against all odds, we imply that audit quality is negatively affected during financial crisis. Moreover, consistent with previous literature, investor protection have a positive impact on audit quality in all clusters except from audit fees which is not correlated with none of the investor protection indexes. In the same vein, we find that there is positive influence of investor protection and financial crisis on audit quality jointly. Further, examining the joint effect of investor protection and audit quality on earnings quality, the results are mixed among clusters and research periods. However, in general, investor protection and auditing have a joint role in the production of higher quality earnings numbers in pre and crisis period. The effects of the interaction terms of investor protection and financial crisis, and investor protection and auditing on audit quality and earnings quality, respectively, are more severe in countries with medium and weak investor protection (clusters 2 and 3).

In Section 2 we set out the theoretical background of the study and in Section 3 we develop the research hypotheses and the regression models. In Section 3 we describe the datasets and in Section 5 we discuss our results. Finally, in Section 6 we present the conclusions, implications and nourishment for future research.

2. Literature review

2.1. Audit quality and investor protection

Papers that examined the fluctuation of audit quality in different investor protection regimes is quietly limited. First, Newman et al. (2005) showed that markets with relatively greater auditor penalties for audit failures and greater insider penalties for detected resource diversion have larger total investment levels, a higher proportion of the firm held by outsiders, higher audit effort, higher audit fees, and higher expected payoffs for both auditors and insiders. In a similar vein, Jaggi and Low (2011) confirmed their expectations that high investor protection is associated with higher audit fees, irrespective of the strictness of securities regulations.

2.2. Earnings quality and investor protection

Investor protection can be seen as an important element of earnings management (Leuz et al., 2003). According to Leuz et al. (2003) and Karolyi (2012), outsider economies with relatively dispersed ownership, strong investor protection and large stock markets exhibit lower levels of earnings management than insider countries with relatively concentrated ownership, weak investor protection and less developed stock markets. In a similar vein, Bushman and Smith (2001), Nabar and Boonlert-U-Thai (2007) and Houque et al. (2012) indicated that earnings are of relatively higher quality in countries with strong investor protection regimes. Furthermore, Guenther and Young (2000) claimed that differences in legal protection