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Earnings quality under financial crisis: A global empirical investigation

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ABSTRACT

This study investigates the impact of the Global Financial Crisis of 2008 on earnings quality in publicly listed firms in advanced countries as per level of investor protection. The sample is categorized into three clusters. Cluster 1 is referred as outsider economies with strong outsider protection and legal enforcement and clusters 2 and 3 are referred as insider economies with better and weaker legal enforcement systems respectively. Using linear regression analysis, 137,091 firm-years observations are analyzed and the earnings quality is examined by using conservatism, value relevance, accruals quality, earnings persistence, earnings predictability, loss avoidance analysis and earnings smoothness. The results show that during the financial crisis, earnings quality is decreased. However, this deterioration on earnings quality appears to be more severe in clusters 2 and 3 which are characterized by medium and weak shareholder protection. Particularly, for all clusters, the study shows that in an attempt to cope with recession, managers have an incentive to choose more aggressive conservatism, lower the earnings predictability and book more accruals. Countries in clusters 2 and 3 report more relevant financial numbers and follow artificial smoothing during the financial crisis while the countries in cluster 1 are to some conflicting.

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1. Introduction

In the last decade, there is an extensive attention from researchers to investigate the determinants and consequences of earnings management. However, they pay more attention on examining the earnings manipulation due to the incentives of managers individually and pay little attention in the economic environment of the firm. With other words, they claimed that the managers incentives are influenced mostly because of a poor cash position; obsolete inventory, receivable that are not collectible; unrealistic revenue and profit expectations; meet analyst's expectations; restrictive loan covenants that the company is violating (Harfenist, 2005). However, the Global Financial Crisis (GFC) of 2008 proved that it influences the managers incentives to produce financial reports that may paint an overly positive picture of a firm's business activities and financial position due to the existence of bankruptcy or delisting. Hence, although there are some evidence that economic downturn influence the earning management during the recent GFC (e.g. Filip and Raffournier, 2012; Kousenidis et al., 2013; Iatridis and Dimitras, 2013), the purpose of this paper is to enhance previous literature in the scope of exploration of the impact of GFC on the quality of earnings on listed firms of advanced countries worldwide.

In accounting and finance literature, several papers have investigated the managers incentives for earnings manipulation. Particularly, Iatridis and Kadorinis (2009) investigated the firms' financial motives for earnings management. They concluded that firms with low profitability and high leverage measures; firms that are in equity and capital need and are close to debt covenant violation; firms that tend to improve their financial numbers and subsequently reinforce their compensation and meet and/or exceed financial analysts' earnings forecasts are likely to use earnings management. Likewise, according to Bergstresser and Philippon (2006), the use of discretionary accruals to manipulate reported earnings is more pronounced at firms where the CEO's potential total compensation is more closely tied to the value of stock and option holdings. Burgstahler and Dichev (1997), Degeorge et al. (1999) and Burgstahler and Eames (2003) and Ayers et al. (2006) provided evidence that firms manage reported earnings to avoid earnings decreases and losses.

Except from firm's attributes which proceed earnings manipulation, there are particular events which may create incentives to manage earnings. Johnson (1999), Conrad et al. (2002), Agarwal et al. (2007), Jenkins et al. (2009), Strobl (2013), Li et al. (2013) examined how earnings management varies over the business cycle. Johnson (1999) documented that earnings are more persistent when growth rates are high (i.e. in an expansion) and production is high (e.g. in an credit crunch period) than when the growth rates are low (i.e. in a recession) and the production is low (i.e. in a reliquification period) respectively. Similarly, Jenkins et al. (2009) demonstrated that the earnings management is sensitive to the business cycle. With other words, conservatism and value relevance of current earnings are higher during economic contractions. Furthermore, according to Strobl (2013), during flourishing periods, firms have incentives to manage earnings upwards while in recession period, the overall performance of a firm declines and at this time managers usually have incentives to manage earnings downwards to conceal earnings in order to save for future needs. Li et al. (2013) also found that economic cyclical fluctuations, as the basic economic operation in the macro economy, can exert a direct influence on the earnings persistence of firms by affecting firm fundamentals as well as earnings management. Therefore, earnings persistence significantly declines when the economic climate worsens. Additionally, Agarwal et al. (2007) provided evidence about banks' earnings management behavior under three distinct economic environment: (a) high-growth with asset price bubble economy (1985–1990), (b) stagnant growth with financial distress economy (1991–1996), and (c) severe recession with credit crunch economy (1997–1999). Their results indicated that banks used security gains as a means to manage earnings throughout all three periods while banks used loan loss provisions to manage earnings during the first two periods.

Consistent with previous literature, several papers deemed that earnings management is sensitive to the occurrence of a bad economic environment. Hence, this study analyzes the impact of GFC period on earnings management by measuring the level and sign of earnings management by advanced countries worldwide over the period of 2005–2012. The choice of advanced countries has several advantages. First, the market capitalization of developed countries through the examined period amount almost 55% globally. Thus, the results are much closer to the reality in relation with other

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