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The effects of the European debt crisis on earnings quality

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ABSTRACT

The present study examines whether and to what extent the recent crisis in the European Union (EU) had an impact on the quality of the reported earnings of listed firms in countries with weak fiscal sustainability (Spain, Greece, Ireland, Italy, and Portugal)—countries that have been forced to apply harsh austerity measures and are practically under financial supervision by EU authorities. This study also examines whether incentives for earnings management, probably induced by the crisis, have led to differential effects in earnings quality. The earnings quality attributes examined include value relevance, timeliness, conditional conservatism, smoothing, management, persistence, and predictability. The reported results show that during the crisis, the change in most determinants of earnings quality favors higher earnings quality. However, the results also suggest that in the case of firms that exhibit the biggest discretionary accruals over a single period, most of the earnings quality attributes signal a decrease in earnings quality. These results persist, even when using controls for extremely poor performance. Therefore, the results of this study indicate that, on average, earnings quality has improved in the crisis period; however, in the presence of incentives for earnings management, earnings quality deteriorates.

1. Introduction

The debt crisis in the EU, although still unfolding, offers a unique opportunity to study its likely effects on the financial reporting quality of firms in the affected countries. For one reason, this is the first crisis to happen since the Economic and Monetary Union (EMU) in Europe, not to mention its magnitude and duration. For another reason, the crisis affected the Eurozone member states in an asymmetric way, by compelling countries with weak fiscal sustainability (Spain, Greece, Ireland, Italy, and Portugal) to request financial support, whereas other countries with strong financial sustainability, like Germany, seemed to be less affected.[1]

The empirical research on the impact of financial crises on affected countries focuses on the crises' likely effects on the performance of international and domestic financial institutions (of the affected country) (i.e., Brealey & Kaplanis, 2004). However, recent evidence by Kutan, Muradoglu, and Sudjana (2012) shows that financial crises bear strong effects not only on the financial sector but also on the real economy sector of the affected countries. In particular, real economy firms face two sorts of problems due to the crisis. First, the poor macroeconomic conditions have deteriorated their operating activities, due to the large reductions in their sales. Second, the near collapse of the banking sectors and the capital markets of these countries have led to shortage in liquidity. These two problems interact. Firms with sustainable real operations have higher likelihood of obtaining financing from either the banks or the market. Moreover, firms with big needs in external financing have a higher disclosure level (Francis, LaFond, Olsson, & Schipper, 2004). Therefore, firms that rely on external financing and struggle with liquidity problems have very strong incentives for increasing their financial reporting quality in order to attract prospective investors. The main objective of this study is to provide evidence for the hypothesis that firms in countries that are most hit by the financial crisis have increased their financial reporting quality in the crisis period (2010–2011). Financial reporting quality is approximated by earnings quality on the justification that earnings are the basis for constructs and measures used by investors (Francis, Olsson, & Schipper, 2006). During a financial crisis, investors and other market participants are more concerned with earnings, which are likely to be volatile, to exhibit a decreasing pattern and, most likely, to incorporate large losses.

However, during a period of poor economic conditions firms may be tempted to engage in "big bath" practices, namely to boost losses by using discretionary accruals. In this case some of the attributes of financial reporting quality, like conditional conservatism (the faster

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[1] In this respect, and keeping in mind that International Financial Reporting Standards have been adopted by all European countries in 2005, we can assume that firms, which are domiciled in the aforementioned group of countries with weak fiscal sustainability, are expected to have been influenced by the crisis in a similar manner regarding their financial reporting quality. These research settings provide a likely fruitful opportunity to examine the financial reporting effects of the recent financial crisis.

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recognition of bad news in relation to good news), are likely to be measured with error. For example, Ball and Shivakumar (2006) show that the presence of discretionary components in earnings decreases the timeliness of earnings. Moreover, the existence of value-irrelevant components of earnings also leads to a decrease in their information content (Hung, 2000). Therefore, firms with higher absolute discretionary accruals likely exhibit higher incentives for earnings management. This consists of the second objective of the study, namely to examine whether differences in financial reporting quality during the crisis period could be attributed to the presence of discretionary accruals.

Like Francis et al. (2004), we classify the earnings quality measures in two groups that correspond to capital market-based and accounting-based measures of earnings quality. The first group of measures, which includes timeliness, conditional conservatism, and value relevance, relies on the assumption that earnings should reflect changes in economic income (as approximated by stock prices). The second group, which includes earnings smoothing, earnings management, and persistence and predictability, relies on the assumption that earnings are used as an effective allocation mechanism of cash flows through accruals (Francis et al., 2004). Therefore, the choice of the specific accounting quality measures is based on the fact that both earnings features (reflection of economic income and allocation of cash flows) are severely impacted by the economic crisis.

To perform our empirical analysis, we use data from the five European countries that face soaring debt and increasing budget deficit problems (Spain, Greece, Ireland, Italy, and Portugal). These countries were forced to adopt a series of harsh austerity measures that have enhanced the shortage of liquidity and the decline in the stock markets. To examine whether the crisis has led to an increase in the quality of the earnings of firms in these countries, we control for the effects of the presence of incentives for earnings management on the change in earnings quality during the crisis period. To perform this task, we first rank firms according to the level of the absolute size of the discretionary accruals in the crisis period; we then sort them into groups of firms, based on the median of absolute discretionary accruals that correspond to low- and high-discretionary accrual groups (low- and high-earnings management groups). We then compute a dummy variable that takes the value of 1, if the firm belongs to the higher discretionary accrual group, and 0 otherwise. Finally we test for changes in the measures of earnings quality during the crisis period, while controlling for differential effects in the low- and high-incentive groups.

Our paper consists of the first comprehensive study of the effects of the EU crisis on various measures of earnings quality. Prior studies with similar focus have investigated the impact of the 1997 Asian crisis on financial reporting (i.e., Davis-Friday, Eng, & Liu, 2006; Graham, King, & Bailes, 2000; Ho, Liu, & Sohn, 2001). However, these studies limit their research interest only to the effects of the crisis on the value relevance of accounting numbers. Moreover, their results do not always explicitly refer to the role of institutional incentives in the decline in value relevance. Our results show that during the crisis period, the change in most determinants of earnings quality favors higher earnings quality. Moreover, we also report that in the case of firms that exhibit the biggest discretionary accruals over the same period, most earnings quality attributes indicate a decrease in earnings quality. These results persist, even when controlling for extremely poor performance. Overall, our results show that earnings quality has increased in the crisis period; however, in the presence of incentives for earnings management, earnings quality deteriorates rather than improves.

The remainder of the paper is organized as follows: Section 2 provides a review of the literature on the impact of financial crises and their effects on accounting quality and financial reporting efficiency. Section 3 analyzes the methodological issues and develops the research hypotheses. Section 4 describes the dataset formation methods and analyzes the empirical results. Finally, Section 5 summarizes the paper and offers implications for further research.

2. Related literature

Empirical research on the impact of financial crises on affected countries shows that financial crises bear strong effects not only on the financial sector but also on the real economy sector of the affected countries (Kutan et al., 2012). The liquidity shortage in the markets that prevails as a counter-effect of the crisis (reduction in the number of IPOs, limitations in bank lending, and a decrease in sales) enhances the need of firms to signal their quality in the market. For example, Francis et al. (2004) show that firms with big needs for external financing have higher disclosure levels. Therefore, the observable implication is that during a crisis, firms with big needs for liquidity are more likely to increase financial reporting quality as a signal to the users of financial statements as well as to obtain external financing.

However, the empirical evidence on the effects of financial crises on the value relevance of accounting information shows that in countries affected by the Asian financial turmoil, the information content of earnings significantly declined during the crisis period (Davis-Friday et al., 2006; Graham et al., 2000; Ho et al., 2001). On the other hand, the information content of book values of equity increased; however, this increase was found not to be able to compensate for the decline in the value relevance of earnings.

In trying to explain these results, we need to stress on the primary role of the financial statements which is to provide users of financial statements with the information required to facilitate their decision-making process.[2] Financial reporting quality plays an important role in capital allocation decisions (Bhattacharya, Desai, & Venkataraman, in press; Francis et al., 2006). Moreover, information of higher quality helps investors to invest more efficiently and to reduce their risk in periods of financial turmoil, when the decisions to allocate capital are affected by the higher volatility of the market and the higher likelihood of investment failure. On the contrary, low-quality information may exaggerate the effects of a financial crisis. Barth and Landsman (2010) find that low-quality financial reporting on asset securitizations, led investors to fail to properly assess the level of risk of investments in banks.

Moreover, we use earnings quality to approximate financial reporting quality, because earnings consist of constructs and measures used by investors (Francis et al., 2006). During a financial crisis period, managers usually concentrate on earnings. For example, Laux and Leuz (2010) report that during a crisis, managers may be tempted to sell assets below their fundamental value in order to preserve firm's profitability. Hence, during a period of financial turmoil, the capital market consequences of changes in earnings quality may play a more profound role in the determination of the financial reporting quality.

Earnings quality has been the topic of numerous studies in the literature. Francis et al. (2004) classify earnings quality measures in two groups that correspond to accounting- and capital market-based measures of earnings quality. The first group of measures includes earnings persistence, smoothing, management and predictability, while the second group includes timeliness, conditional conservatism and value relevance.

Dechow, Ge, and Schrand (2010) examine the validity and usefulness of the determinants of earnings quality. They argue that earnings persistence is a useful attribute of earnings in equity valuation; however, a large fraction of this persistence is due to the cash flow component of earnings rather than the accrual component of earnings; and, in turn, the persistence of the abnormal (discretionary) accruals is lower than the normal component of accruals. Moreover, they refer to findings which indicate that earnings smoothing improves value

[2] IAS 1, Par. 9.