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Integrity of financial information as a determinant of the outcome of a bankruptcy procedure

María-del-Mar Camacho-Miñano [a,*], Domenico Campa [b]

[a] Department of Financial Economics and Accounting II (Accounting), School of Business Administration and Economics, Complutense University of Madrid, Campus of Somosaguas, 28220 Pozuelo de Alarcón, Madrid, Spain
[b] School of Business, Trinity College Dublin, College Street, Dublin, Ireland

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ABSTRACT

The outcome of a bankruptcy procedure – 'liquidation' or 'reorganization' – has many legal, economic and social consequences for stakeholders of financial distressed companies. The objective of this paper is to show whether financial information integrity is a determinant for a 'liquidation' or 'reorganization' decision. Two measures of earnings management as proxies for financial reporting integrity are used on a matched sample of 2064 Spanish bankrupt and healthy companies. The results indicate that only firms which receive a 'liquidation' decision manipulate earnings more than their pairs. This study helps to shed light on the consequences of earnings management during a bankruptcy procedure.

1. Introduction

In economic crises, there is an increasing trend of companies entering into a bankruptcy procedure with serious implications for all stakeholders of firms involved in this process such as a negative social stigma for managers or entrepreneurs, customer and supplier mistrust, labour conflicts, 'doors closed' regarding new loans or grants, impossibility of public contracts, poor image in the society, etc. It means that filing a bankruptcy petition is almost a 'death sentence' for financial distressed firms and the experience has shown that, in many countries, bankruptcy legal procedure is itself a real 'crusher' of firms because the percentage of companies that successfully reorganise their business is quite low (Dewaelheyns & Van Hulle, 2009). For example, the latest Spanish statistics show that nine out of ten financial distressed companies entering into a bankruptcy procedure disappear from the market as consequence of a 'liquidation' outcome (Arias Varona, 2011). Moreover, the performance of bankruptcy law is essential because insolvency codes may condition national economy and growth (La Porta, López de Silanes, Shleifer, & Vishny, 1998; Xu, 2011), investments in one or another country (Pindado, Rodrigues, & De La Torre, 2008) and the development of national entrepreneurship (Lee, Yamakama, Peng, & Barney, 2011).

In this scenario, companies have many incentives to minimise the negative effects economic crises may cause on financial statements (e.g. drop in the demand, financial difficulties, decrease in the level of production, etc.) in order to survive in highly competitive markets and avoid filing for bankruptcy. One of these strategies is, for example, the use of extensive earnings management practices aimed to 'clean' negative signals of financial distress (Jaggi & Lee, 2002; Sweeney, 1994) at the expense of the integrity of firms' annual reports.

While academic literature has already agreed that earnings management is more pervasive among firms close to bankruptcy than healthy ones (e.g. Beneish, Press, & Vargus, 2012; Rosner, 2003), the innovative objective of this paper is to investigate whether the integrity of financial information during the years preceding a legal procedure determines a 'liquidation' or 'reorganization' outcome as exit from a legal procedure for insolvency. Earnings management is used as proxy for the integrity of financial information while the sample includes unlisted companies

* Corresponding author.
E-mail addresses: marcamacho@ccee.ucm.es (M.-d.-M. Camacho-Miñano), campad@tcd.ie (D. Campa).

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operating in Spain which have been involved in a bankruptcy procedure and received either a 'liquidation' or a 'reorganisation' decision and a matched control group of healthy firms.[1] We aim to test whether companies that do not manipulate earnings more than their healthy pairs the years prior to the bankruptcy petition receive a 'reorganization' outcome because they did not 'make up' their annual reports in financial distress situations while companies that manipulate earnings more than healthy companies before the beginning of the bankruptcy procedure receive a 'liquidation' outcome.

The main contribution of this paper is the evidence that there are companies that, despite economic difficulties, are run by managers who do not compromise the integrity of the annual report using more extensive earnings management practices than their healthy pairs. These are also the companies which usually receive a 'reorganisation' outcome from a bankruptcy procedure that allows them to continue the normal conduct of the business. On the other hand, a large proportion of troubled companies use earnings manipulation but they end the bankruptcy process with a 'liquidation' decision which sentences the end of the life of the company. Findings from this paper could also be used to assess the efficacy of a country's legal procedure for bankruptcy evaluating, for example, whether it can correctly distinguish from troubled companies with no signs of compromised financial information integrity (e.g. from the use of more pervasive earnings management) from other, more serious, cases.

The rest of the paper is organised as follows. Section 2 reviews the extant literature, illustrates the bankruptcy procedure in Spain and presents the hypotheses. Section 3 details the sample selection procedure and describes the methodology used to gather evidence in order to test our hypotheses. Section 4 discusses the empirical results and, finally, Section 5 concludes this research highlighting its main implications and limitations.

2. Background and hypotheses

2.1. The integrity of financial statements and the outcome of bankruptcy procedure

The general purpose of financial reporting is to provide high quality information about firms that allows internal and external stakeholders to make coherent decisions (Bushman & Smith, 2001). There are many definitions about what accounting information quality is but international standard-setting bodies and committees consider that it is mainly related to the reliability and transparency of financial statement figures. Another synonym of reliability is integrity and, regardless the numerous definitions of integrity related to finance, there is no doubt that it 'becomes a necessary (but not sufficient) condition for value maximization' (Erhard & Jensen, unpublished results, p. 37). Indeed, investors' confidence in financial reporting was shaken following big scandals involving multinationals such as Enron, Arthur Andersen, Parmalat and WorldCom. Corporate governance legislations around the world, such as the Sarbanes-Oxley Act in the United States, have been issued 'to deal with the increasing concern of investors about the *integrity* of firms' financial reporting' (Lobo & Zhou, 2010, p. 1). Moreover, integrity of financial statements is essential today as it affects firms' ability to gain access to financing (Hope, Thomas, & Vyas, 2011), being, the latter, the main problem of many firms in an environment of economic crisis.

In a general sense, managers prepare financial statements in accordance with accounting rules and their professionalism. However, some situations, as financial distress, provoke incentives for earnings management which is assumed to erode earnings quality and, consequently, the integrity of annual reports, since it generally distorts the picture that accounting earnings paints of the underlying earnings process of the firm (Dechow, Ge, & Schrand, 2010). Furthermore, in bankruptcy situations, earnings management might also lead to serious legal consequences as managers who intentionally alter the actual firm's financial performance might face the payment of a fine (Spanish Act on Insolvency, 2013, Article 164.2) or even be sentenced to prison in case of ascertained frauds (Spanish Penal Code, 2013, Article 290).

Academic literature is clear in the fact that more pervasive earnings management exists among bankrupt firms in comparison with healthy pairs. There are studies that highlight that bankrupt firms use upwards earnings management using several methods such as accounting changes (Lilien, Mellman, & Pastena, 1998), accounting flexibility (Kallunki & Martikainen, 1999), manipulation of accruals (Beneish et al., 2012; García Lara, García Osma, & Neophytou, 2009; Rosner, 2003); aggressive intangible capitalization (Jones, 2011). Bankrupt firms manage also earnings towards a positive target more than their healthy pairs (Charitou, Lambertidis, & Trigeorgis, 2011). There is also some evidence that bankrupt firms manipulate earnings downwards as observed by Charitou, Lambertidis, and Trigeorgis (2007) as well as conflicting results as reported by Leach and Newsom (2007) that provide evidence of upward earnings management five years before the legal procedure while downwards earnings manipulation the two years prior filing for bankruptcy.

Despite all these studies, to the best of our knowledge, there are no papers that have investigated whether the presence of more extensive earnings management conditions the outcome of the legal procedure. Indeed, the extant literature which focuses on the outcomes of a bankruptcy procedure only aimed to develop models that merely indicate which firm-level characteristics predict those outcomes. For example, Barniv, Agarwal, and Leach (2002) provide evidence that smaller companies, firms with higher proportion of debt, companies involved in fraudulent activities and firms where the management does not resign are more likely to be liquidated. Kim and Kim (1999) analyse Korean bankrupt companies which received either 'reorganisation' or 'liquidation' outcome finding that the free assets, existing period, firm size and goodwill are positively related to the probability of 'reorganization' while the liquid assets and operating risk are negatively related to probability of 'reorganization'. In Spain, Andreev and Van Hemmen (2010) investigate which factors can predict the outcome of a legal procedure for bankruptcy finding that higher level of current liabilities and loss of control capabilities are more associated with a 'liquidation' outcome while the higher proportion of tangible assets, the age and the size of firms increase the probability of a 'reorganisation' decision. In addition, using artificial intelligence methodologies, Camacho-Miñano, Segovia-Vargas, and Pascual-Ezama (in press) indicate that their model is able to predict which Spanish bankrupt firms will undergo 'reorganisation' or 'liquidation', before the legal procedure, using only five firm characteristics (sector, size, number of shareholdings, ROA and cash ratio).

As highlighted before, none of the papers reported links the outcome of a bankruptcy procedure to the integrity of annual reports despite the relevance of this document. Indeed, it is one of the main sources of information available to judges, lawyers, auditors, economists during a legal procedure for bankruptcy. If financial statements do not represent the 'true and fair view' of companies, all decisions made on the basis of them might be biased.

[1] Spain is chosen as one of the European countries that are suffering the most the negative effects of the economic crisis occurring at the time this paper is prepared. It results in a significant increase in the number of firms encountering financial distress problem. Indeed, Spain counts 5175, 4984 and 5821 cases of firms entering into a bankruptcy procedure respectively in 2009, 2010 and 2011 from the only 916 and 1033 cases in 2005 and 2006 (National Statistics Institute).