Abstract

This paper discusses the main findings in the literature and offers interesting insights in order to understanding the behavior of firms in times of financial distress. In this respect the occurrence and magnitude of earnings management activities are examined via global financial crisis, bringing into attention the contextual earnings management studies. The main discussions are related to the impact of economic environment on earnings management and further on value relevance of earnings in times of crisis. Since prior research is inconclusive in terms of earnings management occurrence and magnitude in times of financial crisis, future springs of research should be conducted in order to examine if there is a relationship between the financial crisis and earnings management practices.

Keywords: Earnings management, Global financial crisis, contextual earnings management studies

JEL Classification: M40, M41

1. Introduction

The corporate financial performance has been and still is a topic of high interest in both accounting and management literature. Since the financial performance is in the center of economic decision making process, managers are willing to create the perfect image for their companies. On the other hand, financial performance can deteriorate easily for various reasons, conducting to considerable financial losses, managers replacing, bonus cuts or loss of reputation. Therefore, conventional wisdom suggests that managers have important incentives to limit the deterioration of financial performance using both accruals based earnings management and real earnings management. Since financial crisis are known as macroeconomic events that has the potential to lead to financial distress, managers can use more opportunistic measures in those periods. Empirical evidence, however, is inconclusive in this respect.

The view of this paper is related to accounting information and business cycles. Related to earnings management activity, analytical modeling suggest that manipulative activities are more prevalent during economic booms (Cohen and Zarowin, 2010; Strobl, 2013). The main explanation is related to the different incentives that firms have according to the economic conditions. When economic conditions are good, most managers can engage in more prevalent earnings management activity, because most of the firms have higher earnings. In bad economic conditions, incentives for earnings management are lower since the stakeholders expect a large number of companies to have lower earnings. As a result, managers will put a lower emphasis into observed earnings.

Since the application of accounting standards requires professional judgments, sometimes managers use this discretion to create an image of the company that lack economic reality. The incentives game are comprised in this demarche, and previous accounting literature documented so far various incentives that managers have when dealing with earnings manipulation (Ball et al., 2003; Lang et al., 2006; Bushman and Piotroski, 2006; Burgstahler et al., 2006). In this respect much attention is given both to incentives and economic environments that support those incentives. Few studies are focused so far on the macroeconomic events impact on earnings management activity.

Taking into account the fact that stakeholders are interested in the accounting information and base their decision on the performance disclosed by companies, the financial distress in enterprises has long been an issue of concern to both academia and the practical field.

This paper seeks to discuss whether earnings management practices can accelerate in times of crisis taken into account previous research conducted in the literature.

In the light of previous global financial crisis, this subject can be both timely and relevant. A large volume of academic research has investigated so far the factors contributing to accounting choices. Fields et al. (2001) in reviewing this large body of literature asserted that despite this demarche, we still have a limited
understanding of variations in accounting choices across firms. The topic chosen is part of this trend, and is focusing on reviewing accounting choices of firms in times of financial crisis.

This paper proceeds as follows. Section two explains the research methodology employed. Section three provides a brief review of the literature on the association between global financial crisis and earnings management practices. Section four concludes.

2. Methodology

This section explains the research methodology employed. Similar to Guthrie et al (2012), the first step consisted in developing the core objectives of the paper. This step has materialized in the research questions developed below. Second, the articles were selected using keywords specific to earnings management area in relation to financial crisis. The second stage from Guthrie et al. (2012) was missed in this research since the goal was to assess various views found in the literature, from accounting and management field. After downloading the full PDF versions of the papers resulting, a number of 73 papers were examined. From those 31 were excluded based on their marginal view on the relationship between earnings management and financial crisis. The final sample consisted in 42 papers.

The research questions developed are as follows:
- Is financial crisis a prolific moment for companies to engage in earnings management activities?
- Does previous research document the occurrence of earnings management in times of crisis?

3. State of the art

Earnings management activity refers to the use of discretionary accounting employed in order to influence financial statements having the goal of reporting an outcome that is not in line with the economic performance of the company. Earnings management developed in recent years as a specialist field, comprising a large body of literature. The main items approached are related to earnings quality, accrual quality, economic consequences, magnitude and existence (Dechow, 1994; Dechow and Dichev, 2002; Jones, 1991; Leuz et al., 2003). The measures used for earnings manipulation are also assessed extensively in the literature together with both types of motivations that conduct to such activities (e.g. internal and external motivations). Various studies conducted so far in the literature assessed both types of motivations (DeFond and Jamilbalvo, 1994; Holthausen et al., 1995; Burgstahler and Dichev, 1997; Rangan 1998; Teoh et al., 1998a; Teoh et al., 1998b; Degeorge et al., 1999; Dichev and Skinner, 2002; Ayers et al., 2006), documenting empirically various motivations and measures taken by mangers that can vary across the business cycle.

Based on the previous accounting scandals largely documented in the literature, earnings management activity received a considerable attention, conducting so far to a considerable body of research. One main item that appears like a leit motive in earnings management contextual studies is the value relevance of earnings. This particular study is also interested in the value relevance of earnings during contraction years, but moreover interested in the documented existence and magnitude in recession periods.

In this respect, according to Johnson (1999) earnings are more value relevance during contraction years comparing to expansion years. Also, according to Kane et al., (1996) and Richardson et al. (1998), macroeconomic conditions have the potential to affect the relevance of earnings.

Previous research documented both the existence and magnitude of earnings management in extreme situations. One of them is considered to be the financial distress of companies. For instance, Rosner (2003) documented that companies engage in income-increasing earnings manipulation in case of firms that become bankrupt. The author documented in this respect that companies engage in earnings management practices ex ante, when they are financial distress. Studies like the ones conducted by Burgstahler and Dichev (1997), Graham et al., 2005; Charitou et al. (2007), approached earnings management occurrence and magnitude in various economic environments and documented that companies manipulate earnings when experience some kind of financial difficulty.

In the light of previous research, when dealing with financial distress, it seems that managers often turn to manipulation of earnings. Previous literature on the other hand is not so conclusive when it comes to assess the effect of economic financial crisis on earnings management practices. According to Strobl (2013), managers are more likely to engage in earnings manipulations, during an economic boom as opposed to a recession. In the periods of economic boom, managers are more overconfident, they tend to engage more in manipulative accounting practices (Schrand and Zechman, 2012) and employ more optimistic forecasts (Hrribar and Yang, 2011).

Since not many studies were conducted in terms of previous global financial crisis impact on earnings management, this topic can be brought into attention. For instance, empirical evidence from 1997 Asian financial crisis documented that mangers engaged in more income-decreasing earnings management (Saleh and Ahmed...
2005; Ahmed et al., 2008). Saleh and Ahmed (2005) documented that during an economic recession, managers turn to income-reducing earnings management when debt renegotiation having as purpose obtaining support or improved borrowing terms. Also, the authors support the idea that managers lack the incentives to manipulate earnings since the market is more tolerant with lower performance in times of crisis. Assessing also earnings management impact in terms of debt renegotiations, Ahmed et al. (2008) found an income-decreasing earnings management. Alternatively, managers realizing that the market tolerates poor performance during a recession, they may have depressed earnings further for the benefit of managers, via accruals using a ‘big bath’ method. Chia et al. (2007) document similar results with previous two studies assessed above, and found that service-oriented companies in Singapore engage in income-decreasing earnings management during the crisis period also.

When approaching the proxies for earnings management activity, the large majority of studies turn to discretionary accruals. Being a component of accruals, discretionary accruals segments are entirely under the management discretion. In this respect, managers can use this discretion to convey useful information or they can use it for opportunistically purposes. The view of this paper is concerning the second item. When managers use discretionary accruals for opportunistic reasons, they arerationally discounting accruals and introduce in the managerial discretion a self serving bias. When dealing with allowance for bad debts, depreciation, depletion or amortization, managers are given significant discretion over accrual reporting and take advantage of accounting discretion to opportunistically manage reported earnings. Studies like the ones conducted by Hung (2001); Xie (2001); Krishnan (2003); Francis et al. (2004, 2005) or Kim and Yi (2006) are part of this trend and document empirically managerial discretion used opportunistically. Previous research also documented that managers are likely to manipulate earnings in times of crisis in order to avoid the decline of the firm’s stock price that would negatively impact their compensation (Charitou et al., 2007). Similar results are obtained in terms of debt covenants (Dichev and Skinner, 2002; Iatridis and Kadorinis, 2009).

Studies like the ones conducted by Jones (1991) or Lim and Matolcsy (1999) documented the existence of earnings management practices used in order to obtain advantages from the government. Those previous arguments, explore the relationship between economic downturn and earnings management.

On the other hand the main argument for managers to engage in earnings management activities is related to the decline of firm performance during financial crisis. This can act like a strong incentive for managers to follow with the scope of camouflaging the true performance of the companies. Conservatism is also assessed (Jenkins et al., 2009) and found to be one argument for lower levels of earnings management in times of financial crisis, when the influence of litigation risk on conservatism is well documented in the literature (Willekens and Bauwhede, 2003; Huijgen and Lubberink, 2005; Krishnan, 2007).

Previous findings imply that negative accruals are preferred by managers during recessions, even if some authors documented increased accruals. Since, investors’ confidence on financial reporting quality declines during a financial crisis they tend to associate discretionary accruals more with managerial opportunism rather than efficient signaling. They also, tend to accept that lower earnings are obtained and further accept lower performance. It is for this reason why Jenkins et al. (2009) reported that accounting conservatism and value relevance of earnings are higher during economic contractions since firms generally report more conservatively to avoid sharp increases in litigation risk and regulatory scrutiny during recession.

4. Conclusion and scope for future research

The previous global financial crisis had significant consequences on the level of economic activity, as it was documented by a large body of literature. When it comes to exploring the managers’ incentives and firms’ behavior in times of crisis, very few studies were conducted so far. These findings highlight the need for contextual earnings management studies. Another argument in favor can be the inconclusive results obtained so far in the literature when dealing with the impact of macroeconomic conditions on earnings management activities. The 2008-2009 global financial crisis assessment via earnings management seems to lack sufficient empirical documentation. In this respect very few studies were conducted and documented that earnings management decreases. One argument for the lower level of earnings management in recession periods may be found in the higher demand for conservative earnings.

When assessing the results documented from the Asian financial crisis, the authors cited above documented both increasing and decreasing earnings management magnitude. For the increasing earnings management practices, authors documented mainly external incentives that mangers can have in the light of such macroeconomic events.

Since there are a number of reasons to sustain the idea of earnings management practices increasing in times of financial crisis, the first research question approached turn to the increase of opportunistic behavior in times of crisis. Based on the literature the results are inconclusive since it is unclear whether economic crises have the potential to incite firms to manipulate their earnings or just to report unbiased and conservative earnings. The second question also found inconclusive answers in the literature.
This opens the road to future empirical research in contextual earnings management studies, to assess the impact of macroeconomic events on the behavior of firms and to assess further the absence or existence of above documented differences. Also, future research can examine the psychological traits of managers that can have incremental explanatory power over economic incentives via earnings management and recession periods.

5. References

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