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Earnings Management and Audit Quality in Europe: Evidence from the Private Client Segment Market

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Abstract

This paper contributes to the recent literature on financial reporting quality in private (i.e. non-listed) companies (Ball and Shivakumar, [2005](#); Burgstahler et al., [2006](#)) by examining whether in these types of companies Big 4 audit firms, as high quality auditors, provide a constraint on earnings management. Considering incentives of auditors to supply a high audit quality in private firms, we expect that Big 4 auditors have an incentive to constrain earnings management only in high tax alignment countries, where financial statements are more scrutinized by tax authorities and the probability that an audit failure is detected is higher. Using data on private firms in European countries, this study provides evidence consistent with this expectation.

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Notes

For convenience we use the term Big 4 auditor to identify the large international audit firm networks (Big 6/5/4). Some of the studies we refer to were conducted before the mergers resulted in a reduction to four international audit networks. Up to 2002, Big 5 audit firms included PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young, KPMG and Arthur Andersen. In 2002, Arthur Andersen disappeared after the high profile financial scandal in its client firm Enron.

It can be argued that in low tax alignment countries with a higher litigation risk (such as the UK), Big 4 auditors will also have an incentive to constrain earnings management to avoid private litigation (for example, bank lawsuits). To control for this, we perform a sensitivity analysis (see [Section 4](#)) with a litigation index as control variable. From this analysis, it appears that litigation does not provide incremental explanatory power above tax alignment in explaining cross-country variation in audit quality differentiation.

Amadeus is a database containing financial data of public and private firms in Europe. Due to data limitations (see [Section 3.1](#)), we could only include 6 out of the 15 EU member states in 2002.

In accordance with the Fourth Council Directive (78/660/EEC) of 25 July 1978 only small companies are exempted from a statutory audit. During our sample period 1998–2002, small companies are companies that do not exceed more than one of following criteria:

(a) average number of employees: 50; (b) balance sheet total: 3,125,000 EUR; (c) annual net turnover: 6,250,000 EUR. Companies with more than 100 employees are always considered as large companies. These exemption criteria have, however, been revised over time. Since 2005, small companies are defined as companies with less than 50 employees and whose annual turnover or annual balance sheet total does not exceed 10 million EUR.

While the exercised discretion in reporting earnings can also be used to signal private information and reduce information asymmetry (e.g. Subramanyam, [1996](#)), we assume earnings are managed for opportunistic reasons to mislead some stakeholders or influence contractual outcomes, following the definition of Healy and Wahlen ([1999](#)).

See note 4.

Similar to DeFond and Hung ([2004](#)), we define investor protection as 'the extent of laws that protect investors' rights and the strength of the legal institutions that facilitate law enforcement'.

Tax enforcement is considered to be stronger in high tax alignment countries with respect to financial statements and with respect to the auditors, which are considered to provide assurance over the accuracy of these financial statements. We hereby do not claim that tax authorities are better at enforcing tax law in these countries compared to low tax alignment countries.

However, increased enforcement due to the increased scrutiny of financial statements by tax authorities does not appear to lead to less earnings management in countries with a strong tax alignment, as indicated by the results of Burgstahler et al. ([2006](#)). They argue that stronger tax alignment is associated with more earnings management, since companies have more direct incentives to influence financial reporting income to minimize their tax expense when this income figure is taken as the basis for taxation.

For example, KPMG tax shelter fraud in 2005.

Listing status and audit firm data is provided in Amadeus only for the final year. Therefore, previous versions of the Amadeus database were used to verify the listing status and audit firm data.

Financial institutions are excluded because of their specific accounting requirements, which differ substantially from those of industrial and commercial companies. Public

administrative institutions are excluded because of their specific nature. Similar to Fenn ([2000](#)) we exclude subsidiaries of quoted companies as their management and financial reporting decisions are likely to be influenced by public parent companies.

This makes the calculation of EM2, described in [Section 3.2](#), impossible.

Following Dechow et al. ([1995](#)), we compute total accruals as $(\Delta\text{total current assets} - \Delta\text{cash}) - (\Delta\text{total current liabilities} - \Delta\text{short-term debt}) - \text{depreciation expense}$, where Δ denotes the change over the fiscal year.

While a negative correlation between accruals and operating cash flow is inherent to accrual accounting, differences in the magnitudes of this correlation indicate, *ceteris paribus*, variation in the extent of earnings smoothing. Moreover, because accounting systems likely underreact to economic shocks, using accruals to signal firm performance results on average in a less negative (and in specific cases even positive) correlation with cash flows (Leuz et al., [2003](#)).

While Spain theoretically experienced a great reduction in tax alignment in the early 1990s, in practice a strong tax link still exists in Spanish individual financial statements (Oliveiras and Puig, [2005](#)).

This variable is the same as the institutional variable used by Burgstahler et al. ([2006](#)).

We truncate firm-level realizations at the 0.5 and 99.5 percentile before computing subgroup medians.

We have also performed our analyses with EM2 excluded from the aggregate earnings measure. Our conclusions with respect to audit quality differentiation and tax alignment remain qualitatively similar.

Comparison of this list with the 1999 list revealed only one difference. In 2002 one firm had been replaced by number 23 of 1999.

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