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

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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.

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(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 a

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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 (Δtotal current assets − Δcash)−(Δtotal current liabilities − Δshort-term debt)−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).

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