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Earnings quality and accruals over company´s life cycle

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Introduction

➢ expected decline in the world economy - 7.9% (OECD Economic Outlook, 2020)

➢ growth of corporate insolvencies in small export-oriented economies of Central Europe - 38% to 20% (Euler Hermes, 2020)

➢ increasing emphasis on the quality of financial statements and exposing earnings management

➢ referring to Hastuti, et al (2017), Chen (2016), You & Du (2019), Hribar & Yehuda (2015) profit manipulation changes with the life cycle stage

Aim of the study

The paper examines the impact of the life cycle and country specific factor on the value of discretionary accruals in the tourism sector of the Visegrad countries.

Corporate life cycle

➢theories vary depending on the purpose as a managerial view or a financial view of the life cycle

➢Damodaran distinguishes 6 phases of the life cycle - Start-up, Young Growth, High Growth, Mature Growth, mature Stable and Decline

➢Dickinson model distinguishes life cycle stages according to cash flow patterns - Introduction, Growth, Maturity, Shake-out, Decline

➢different financial performance in life cycle stages - different space for profit manipulation

Model

$$EM_i = \mu + Country_j + Life\ cycle_k + Country \cdot Lifecycle_{j \cdot k} + \varepsilon_{ijk}$$

➢ EM_i – earnings management proxy, discretionary accruals by Modified Jones model

➢ $Country_j$ - qualitative variable {The Czech Republic, Hungary, Polans Slovakia}

➢ $Life\ cycle_k$ - qualitative variable {Introduction, Growth, Mature, Shake-out, Decline} defined by Dickinson (2011)

➢ $Country \cdot Lifecycle_{j \cdot k}$ - interaction term

Cash flow patterns and corporate life cycle

Cash flow	Introduction	Growth	Mature	Shake-out			Decline	
Operating	Neg.	Pos.	Pos.	Neg.	Pos.	Neg.	Neg.	Neg.
Investing	Neg.	Neg.	Neg.	Neg.	Pos.	Pos.	Pos.	Pos.
Financing	Pos.	Pos.	Neg.	Neg.	Pos.	Neg.	Pos.	Neg.

Methods and sample

➤ Two-way ANOVA with interaction

➤ Sample

  ➤ Gross sample – 15 295 companies

  ➤ Net sample (without missing data and outliers) – 3 650 companies

  ➤ Analysed period - 2018

  ➤ Criteria for the selection :

    ➤ Turnover > 200,000 Eur

    ➤ Country affiliation – Visegrad Four

   ➤ Nace Rev. 2 Main sector - Accommodation and food services activities

Results

Factor	Earnings management proxy (discretionary accruals)				
Country	Mean	Median	Std. Deviation	% of Total N	N
the Czech Republic	0,0221	0,0470	0,4588	37,80%	1381
Hungary	0,0054	0,0164	0,1941	4,90%	180
Poland	0,0068	0,0203	0,2434	28,40%	1035
Slovakia	0,0559	0,0812	0,5548	28,90%	1054
Life cycle stage					
introduction	0,4018	0,2889	0,4116	7,60%	278
growth	0,0993	0,0734	0,3228	21,00%	768
mature	-0,0748	0,0102	0,2992	22,80%	832
shake-out	-0,0686	0,0058	0,4805	39,00%	1422
decline	0,1984	0,1331	0,4779	9,60%	350

Source	Type III Sum of Squares	df	Mean Square	F	Sig.	Partial Eta Squared
Corrected Model	81,384a	19	4,283	25,802	0,000	0,119
Intercept	10,733	1	10,733	64,653	0,000	0,017
Country	1,997	3	0,666	4,009	0,007	0,003
Life cycle	26,479	4	6,620	39,876	0,000	0,042
Country * Life cycle	5,741	12	0,478	2,882	0,001	0,009
Error	602,612	3630	0,166			
Total	686,600	3650				
Corrected Total	683,996	3649				

a. R Squared = ,119 (Adjusted R Squared = ,114)

Estimated Marginal Means of Earnings_management
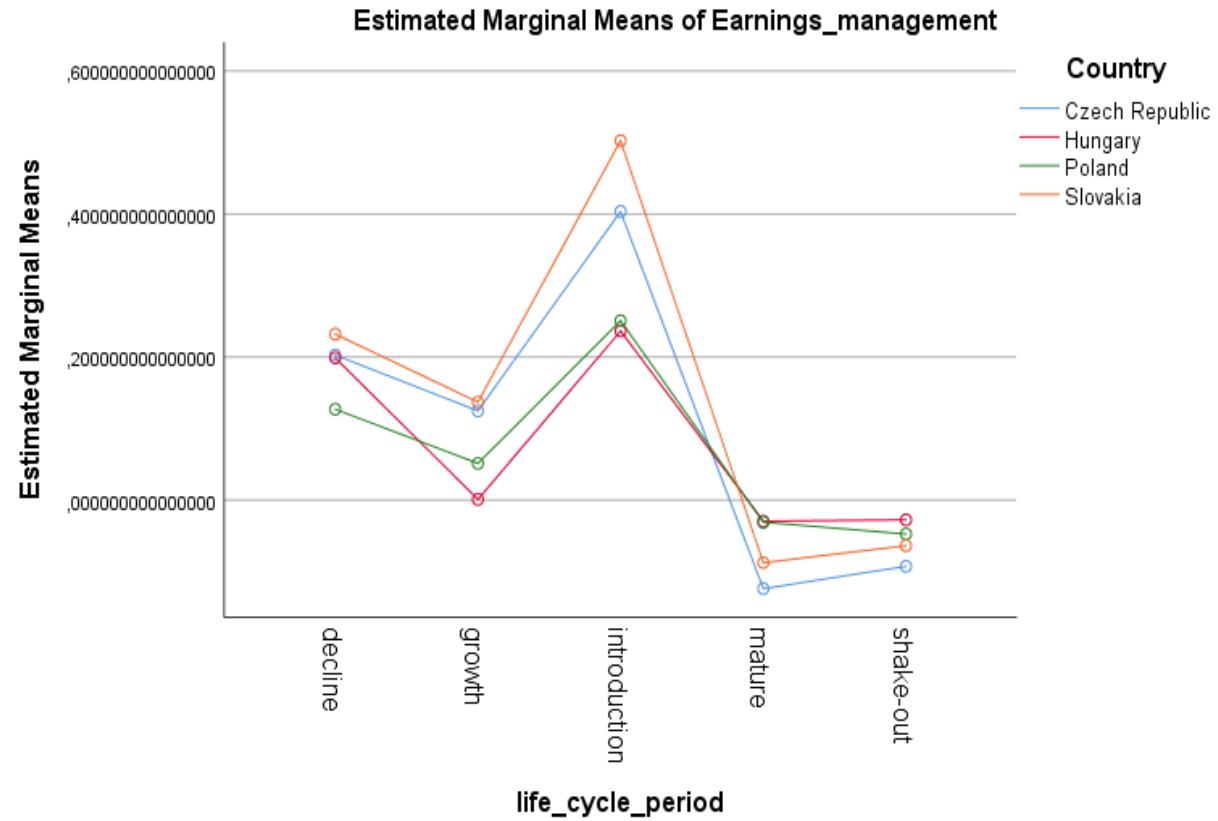
➤the level of earnings management at different life cycle stages varies across countries

Country significant difference (post hoc tests)	the Czech Republic	Hungary	Poland	Slovakia
introduction - growth	H1	H1	H1	H1
introduction - mature	H1	H1	H1	H1
introduction - shake-out	H1	H1	H1	H1
introduction - decline	H1	H0	H1	H1
growth - mature	H1	H0	H1	H1
growth - shake-out	H1	H0	H1	H1
growth - decline	H0	H1	H0	H0
mature - shake-out	H0	H0	H0	H0
mature - decline	H1	H1	H1	H1
shake-out - decline	H1	H1	H1	H1

Discussion

➢ significant differences in earnings quality across life cycle

➢ low operating profit of falling and rising companies – room for earning manipulation

➢ Hungarian subsample – low difference between quality of profit if operating profit is negative

➢ the difference in earning quality between life cycle stages is higher than the difference between countries

➢ the possibility of applying the proxy life cycle in the model of discretionary accruals for companies in Central and Eastern Europe

for further questions, please, contact at
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