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The Moderation Effect of Financial Distress on the Relationship Between Market Power and Earnings Management of Firms

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Abstract : To the best of our knowledge, this is the first study to have analyzed the impact of a) firm-specific product-market power and b) industry competition on earnings management behavior of European firms in distress versus healthy years while controlling for firm-level characteristics. We predicted a significant relationship between firms' product market power and earnings management tools and their trade-off under the moderation effect of financial distress. We found that the firm-level market power hereinafter referred to as MP (proxied by the industry-adjusted Lerner Index) is positively associated with both real and accrual earnings management. However, MP is associated with a higher level of real earnings management compared to accrual earnings management in distress years compared to healthy years. On the other hand, industry product market power (representing low competition and proxied by the inverse of the total number of firms in an industry hereinafter referred to as NUMB) and firms product market power (proxied by firm market share hereinafter referred to as MS) are associated with lower inflationary accruals and higher deflationary accruals respectively. On the other hand, they are found to be linked with higher real earnings management in distress versus healthy years. When we divided the sample into small and big firms based on their respective industry-year median total assets, we found that all three measures of industry competition (Industry Median Lerner Index (hereinafter referred to as IMLI), NUMB, and Herfindahl–Hirschman Index (hereinafter referred to as HHI) indicate that small firms in low-competitive industries in financial distress are more likely to inflate their earnings through discretionary accruals. While big firms in this situation are more likely to lower the use of both inflationary and deflationary discretionary accruals as indicated by IMLI and HHI and trade-off accruals earnings management for real earnings management as indicated by NUMB. Moreover, IMLI and HHI did not show any interesting results when we divided the sample based on the firm Lerner Index/Market Power. However, the distressed firms with high market power (MP>industry median) are found to engage in income-decreasing discretionary accruals in low-competitive industries (high NUMB). Whereas firms with low market power in the same industry use downward discretionary accruals but inflate income using real activities (abnCFO). Our findings are robust across alternate measures of discretionary accruals and financial distress, such as the Altman Z-Score. The finding of the study is valuable for accounting standard setters, competition authorities, policymakers, and investors alike to help in informed decision-making.

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