Creative Accounting in Spain.
Some Evidence from Spanish Quoted Companies
Oriol Amat, Catherine Gowthorpe, Jordi Perramon

Abstract

The nature and incidence of earnings management practices have been examined in many research studies, especially in the United States. Research into such practices in Europe, and specifically in Spain has been less common. This paper makes a contribution to the existing literature by offering an analysis of certain features of Spanish accounting that can be classified as earnings management. The population of companies under review comprises those included in the IBEX-35 index, and so includes the largest companies in Spain. The effects upon earnings of four commonly encountered features in Spanish accounting practice are examined and quantified: audit report qualifications, special authorisations to override accounting regulation, changes in accounting policy and extraordinary items. The results of the analysis show that net earnings are affected to a significant extent by these items. The paper concludes that these relatively overt forms of earnings management are employed in the financial statements of several leading Spanish companies. While a reduction in the level of options offered by accounting regulation may help to reduce the incidence of earnings management, it is noted that a tightening of standards in one area tends to simply shift the location of earnings management. Remedial measures should, therefore, also include improvements in supervision.

Keywords: Earnings management, financial reporting, Spain, IBEX-35

Introduction

This paper examines the incidence of overt earnings management in larger Spanish listed companies. The population of companies selected for analysis comprises the IBEX-35 companies listed on the Madrid Stock Exchange. (The IBEX-35 is an index calculated using the share price variations of the 35 largest Spanish companies). These companies are highly significant players in the Spanish economy and, in consequence, they can be expected to be subject to quite detailed scrutiny by the principal groups of users of financial statements. The analysis reported has been performed on publicly available information contained in the annual reports of the companies under review. There might seem little point in attempting to adjust the earnings of prominent companies by the use of relatively overt methods; the level of scrutiny to which they are naturally exposed should mean that any unusual features would be identified and absorbed by the market without delay. Nevertheless, this paper will show that several major Spanish companies do appear to manipulate their reported earnings by quite overt means. The degree to which users

1. Professor of Accounting, Universitat Pompeu Fabra, Barcelona.
2. Research Fellow in Accounting, Oxford Brookes University.
3. Lecturer in Accounting, Universitat Pompeu Fabra, Barcelona.
are successful in identifying earnings management at this level is beyond the scope of the paper and further research is required.

The paper is structured as follows: first, some of the principal theoretical underpinning relating to earnings management is discussed. The review of literature is then broadened to examine definitions of earnings management, motivations for its use, and various empirical studies that have sought to identify its existence, nature and incidence. Some relevant and interesting features of the Spanish accounting environment are examined, and then the empirical work is reported. The paper identifies four principal types of earnings management indicator: audit report qualifications, special authorisations from regulatory agencies, changes in accounting policy and extraordinary items. The impact of these items on the reported net earnings of several major Spanish companies is quantified. Following a discussion of the results, the study concludes by identifying its principal limitations and suggesting further avenues for research.

Theoretical considerations

Agency theory provides the conceptual underpinning for many studies of earnings management. The firm operates not as a separate legal personality, but rather constitutes a ‘nexus of contracts’ between individuals: ‘The firm is not an individual. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations.’ (Jensen and Meckling, 1976). Within the agency framework, it is both logical and inescapable that management behaviour will be self-serving. Agency can, therefore, provide a solid framework for the understanding of earnings management behaviour. However, it may provide an incomplete theoretical basis for explaining or predicting management behaviour; the ethical dimension of human behaviour may provide an important element missing from legalistic and adversarial agency relationships (Horrigan, 1987).

The informational perspective (Schipper, 1989) is a key element underpinning the study of the earnings management phenomenon. A conflict is created by the information asymmetry that exists in complex corporate structures between a privileged management and a more remote body of stakeholders. Managers may choose to exploit their privileged position for private gain, by managing financial reporting disclosures in their own favour. The informational perspective assumes that accounting disclosures have an information content that possesses value to stakeholders in providing useful signals.

It may be difficult or impossible for individual stakeholders to discern the fact and the effect of accounting manipulation, because of an insufficient personal skill set, indifference or an unwillingness to engage in detailed analysis (the mechanistic or naïve investor hypothesis, discussed by Breton and Taffler, 1995). From a market efficiency perspective such failures in under-

4. There have been several studies of earnings management issues from an ethical perspective: e.g. Merchant and Rockness (1994), Bruns and Merchant (1990) and Fischer and Rosenzweig (1995).

5. However, the credibility and value of that information is frequently questioned. Dipiazza and Eccles (2002) cite some findings of a recent study by PricewaterhouseCoopers: only 20% of analysts investors and executives consider that information prepared under current GAAP is useful in presenting a faithful image of companies.
standing may not matter. Breton and Taffler point out in the conclusion to their study establishing that analysts’ perception of creative accounting devices is somewhat deficient, only a small number of effective accounting experts may be required ‘for the market as a whole appropriately to process window dressed numbers’. On the other hand, Healy and Wahlen (1999) cite studies that find that earnings management prior to equity issues does affect share prices, suggesting that investors do not necessarily see through earnings management.

The research reported in this study is positioned within an informational perspective, tempered by the naïve investor hypothesis; it is based upon the propositions, firstly, that financial reporting does possess valuable information content, and secondly that distortions in it may not be readily discernible by all stakeholders or that their effects may not be truly appreciated.

**Literature review**

There is a substantial literature on earnings management, much of it originating in, and concerned with, the United States. However, the US literature offers valuable insights into earnings management in any country with a reasonably highly developed capital market (a recent comprehensive review of the US literature is provided by Healy and Wahlen, 1999). Also, beyond the US, there has been a growth in the volume of literature discussing earnings management issues.

**Definitions of earnings management**

Earnings management is referred to also as: creative accounting, income smoothing, earnings smoothing, financial engineering and cosmetic accounting. The preferred term in the USA, and consequently in most of the literature on the subject is ‘earnings management’, and so this is the term that will be used in this paper. However, it should be recognised that some accounting manipulation involves primarily balance sheet rather than earnings management. Definitions of earnings management vary, and include the following:

a) ‘Income smoothing [earnings management] is the deliberate dampening of fluctuations about “some level of earnings considered to be normal for the firm”’ . (Barnea et al. 1976)

b) ‘Earnings management is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental’. (Merchant and Rockness, 1994)

c) ‘Income smoothing [earnings management] involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared’. (Copeland, 1968)

Schipper (1989) observes that ‘earnings management’ can be equated with ‘disclosure management’, ‘in the sense of a purposeful intervention in the financial reporting process’. This approach excludes the category of smoothing device that involves delaying or hastening transac-
tions so that they can be reported in an earlier or later accounting period. Indeed, Copeland (1968) would also exclude such devices; his definition of a perfect smoothing device includes the point that it should not involve any real transaction with second parties.

Motivation for earnings management

Various research studies have examined the issue of management motivation towards earnings management behaviour. Half a century ago, Hepworth (1953) identified several motivations including the existence of tax levies based on income, confidence by shareholders and workers in management that is able to report stable earnings and psychological expectations relating to increases or decreases in anticipated income. Tax is mentioned as a significant motivator also by Niskanen and Keloharju (2000) in a Finnish context and in Japan by Herrmann and Inoue (1996). Beidleman (1973) observes the positive effects of income smoothing on expectations, securities valuation and some element of risk reduction for analysts. Other motivations for earnings management discussed by Healy and Wahlen (1999) include those provided when significant capital market transactions are anticipated, and when there is a gap between the actual performance of the firm and analysts’ expectations. Healy (1985) examines managers’ earnings manipulations motives where executive compensation is linked to income measurement. Trueman and Titman (1988) discuss managers’ motivations to reduce the perception of variability in underlying economic earnings of the firm. Kamin and Ronen (1978) observe a difference in motivation between managers in owner-controlled and management-controlled firms. Owners who wish to retain control of a sizeable stake and who are therefore not interested in immediate exit strategies are less likely to be motivated to manage earnings.

Existence of earnings management

Even though managers’ motivation for earning management may be established and accepted at least in theory, establishing empirically that it takes place is a separate problem. Several studies have attempted to model earnings management behaviour and to prove its existence through the analysis of (often very) large datasets (e.g. Barnea et al. 1976; McNichols and Wilson, 1988; Dascher and Malcom, 1970 and Black et al, 1998). An alternative approach is taken by Naser and Pendlebury (1992) who questioned senior corporate auditors about their experience of creative accounting. They were able to conclude that a significant proportion of all categories of company employ creative accounting (earnings management) techniques to some extent. Merchant (1990) examines management manipulation of accounting information within two firms (i.e. information used in internal reporting by divisions) drawing upon both interview and questionnaire data. The research found that ‘managers acknowledged manipulative behaviours and short-term orientations’.

Many research studies (some of which are examined in the section immediately below) examine a particular aspect or technique of earnings management. All tend towards the conclusion that earnings management using that particular technique does exist.

6. De Angelo (1988), however, points out that the design of such studies presents problems.
Techniques of earnings management

Various techniques of earnings management emerge from the literature. Much of the genuine management of earnings (as opposed to, say, managing gearing so as to improve proprietary ratios) centres upon the management of accruals of various types. McNichols and Wilson (1988) model the non-discretionary component of the bad debts provision (so as to identify the discretionary element of the accrual). Barnea et al. (1976) discuss classificatory smoothing with the use of extraordinary items; their results, based on a study of 62 US companies, indicate that classificatory smoothing does take place. A later large scale study of classificatory smoothing (Dempsey et al., 1993) found that ‘managers showed a propensity to report extraordinary gains on the income statement and extraordinary losses on the retained earnings statement’. Moreover, this research found that the propensity to report in this way was significantly greater in non-owner managed firms. Dascher and Malcom (1970) analysed data over several years for 52 firms in the chemical industries sector relating to four income smoothing variables: pensions costs, dividends from unconsolidated subsidiaries, extraordinary charges and credits and research and development costs. They concluded that their results were consistent with the hypothesis that deliberate smoothing had taken place. Large provisions against uncertain levels of future loss are highly dependent upon the judgements made by management. Healy and Wahlen (1999) cite several studies that find ‘compelling evidence’ of income smoothing via accruals in banks and insurers, for example, Beatty et al. (1995).

Black et al. (1998) examine non-current asset sales as earnings management tools, using a very large dataset of observations from Australia, New Zealand and the UK. They find that, where the relevant accounting standards are permissive (as in the UK up till 1993) managers will exploit the potential for earnings management via timing of asset sales. Such behaviours are curtailed once the provisions of accounting standards are tightened. However, amongst their conclusions, they observe that ‘there is every reason to believe that firms can “shift” earnings management activity among a variety of methods’. So, even if certain loopholes in regulation are eliminated, earnings management behaviour is likely to persist.

Balance sheet (as opposed to earnings) management is relatively under-explored in the literature. However, the study by Gramlich et al. (2001) suggests that firms engage in balance sheet manipulation to reclassify liabilities in order to smooth reported liquidity and leverage ratios.

A special type of earnings management relates to the presentation of financial numbers, based on cognitive reference points. As explained by Niskanen and Keloharju (2000): ‘the idea behind this behaviour is that humans may perceive a profit of, say, 301 million as abnormally larger than a profit of 298 million’. Their study and others (e.g. van Caneghem, 2002) have indicated that some minor massaging of figures does take place in order to reach significant reference points.

The potential for earnings management

The potential for earnings management is found in three principal areas: regulatory flexibility, a dearth of regulation and scope for managerial judgement in respect of assumptions about the
future. Even in a highly regulated accounting environment such as the USA, a great deal of flexibility is available (Largay, 2002; Mulford and Comiskey, 2002). Taking each of the three areas in turn:

1. Regulatory flexibility. Accounting regulation often permits a choice of policy, for example, in respect of asset valuation (in international practice, for example, IAS 16 permits a choice between carrying non-current assets at either revalued amounts or depreciated historical cost). Business entities may, quite validly, change their accounting policies. As Schipper (1989) points out, such changes may be relatively easy to identify in the year of change, but are much less readily discernible thereafter.

2. Dearth of regulation. Some areas are simply not fully regulated. For example, there are (as yet) very few mandatory requirements in respect of accounting for stock options. In Spain, accounting regulation in some areas is limited: for example the recognition and measurement of pension liabilities and certain aspects of accounting for financial instruments.

3. Management has considerable scope for estimation in discretionary areas. McNichols and Wilson (1988), for example, examine the discretionary and non-discretionary elements of the bad debts provision.

Earnings management research outside the US

As noted above, the majority of research studies are based on US evidence and are undertaken by US authors. However, there has been some interest in earnings management elsewhere, especially perhaps in the UK. Following a series of accounting scandals during the 1980s interest in the topic burgeoned and several texts were published: Griffiths (1986 and 1995); Smith (1992); Naser (1993) and McBarnet and Whelan (1999). Specific studies that analyse earnings management practices outside the US include: Black et al. (1998) – Australia, New Zealand and the UK; Niskanen and Keloharju (2000) – Finland; and Jones et al. (2001) – Australia.

Eilifsen et al. (1999) model income disclosure options within the context of a close link between taxable profits and accounting profits, observing that linked accounting and tax income ‘provides, in a weak sense, at least’, an automatic safeguard against unwanted earnings manipulation of financial statements’. Although this study is not country-specific, it clearly has relevance to the countries of continental Europe where a close link between tax and accounting income has been the norm. In recent years, however, the link has tended to weaken throughout Europe, thus opening the possibility that the incidence of earnings management behaviour will increase. It should also be noted in this context that the deterrent (even if ‘weak’) offered by the tax-accounting link, would not apply to accounting statements (such as consolidated financial statements) that do not form the basis of actual taxation charges.

7. But note, however, Black et al.’s (1998) comments about the ‘shift’ that takes place in earnings management behaviour if the earnings management potential latent in certain accounting standards is eliminated through a tightening of the rules.
There has been relatively little research on earnings management in Spain (but see Giner, 1992), although awareness of the topic was raised by the publication of a book on creative accounting in 1996 (Amat and Blake, 1996).

The Spanish accounting environment

Substantial differences continue to exist between the accounting regulatory regimes of different countries, despite the move towards international harmonisation (Street et al. 2000). Differences tend to persist in areas such as asset valuation, revenue and expense recognition and measurement, depreciation and amortisation, recognition of provisions and liabilities, accounting for stock options, foreign currency, derivatives and discounting. The reconciliation to US GAAP of those Spanish companies that are listed in both Madrid and New York is illustrative of the degree of difference. Table 1 shows 2001 data for all seven companies in this category. In all cases, earnings under US GAAP are lower than under Spanish accounting regulation.\(^8\)

<table>
<thead>
<tr>
<th>Company</th>
<th>Net income: Spanish GAAP</th>
<th>Net income: US GAAP</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBVA</td>
<td>+2,363</td>
<td>+680</td>
<td>+1,683</td>
</tr>
<tr>
<td>Endesa</td>
<td>+1,479</td>
<td>+1,034</td>
<td>+445</td>
</tr>
<tr>
<td>SCH</td>
<td>+2,486</td>
<td>+2,176</td>
<td>+310</td>
</tr>
<tr>
<td>Repsol</td>
<td>+1,025</td>
<td>+980</td>
<td>+45</td>
</tr>
<tr>
<td>Telefónica</td>
<td>+2,106</td>
<td>−7,182</td>
<td>+9,288</td>
</tr>
<tr>
<td>Telefónica Móviles</td>
<td>+893</td>
<td>+320</td>
<td>+573</td>
</tr>
<tr>
<td>Terra</td>
<td>−566</td>
<td>−11,411</td>
<td>+10,845</td>
</tr>
<tr>
<td>Total</td>
<td>+9,786</td>
<td>−13,403</td>
<td>+23,189</td>
</tr>
</tbody>
</table>

Within Spanish GAAP, as elsewhere, there is a great deal of scope for variation within reported results (Lainez et al., 1999).\(^9\) For example in valuing inventories, Spanish accounting regulation currently permits the adoption of average cost, FIFO or LIFO. The differences in reporting profits can be substantial depending upon which policy is selected by management.

---

8. The very large differences are caused in many cases in 2001 by the accounting rules relating to accounting for goodwill. US rules require that goodwill should be assessed for impairment; in 2001, with a stock market in freefall, impairment losses were substantial. In Spain, by contrast, goodwill is written off on the straight line basis usually over a period of 20 years.

9. One of the authors of this paper has estimated the effects, in 2000, on a particular Spanish company of applying the most and least conservative policies available. Taking a base of 100 to represent the most commonly applied accounting policies in Spain, application of the most conservative policies results in a comparative index number of -31. Application of the least conservative policies available results in a comparative index number of +140.
However, there are some unusual features of the Spanish accounting environment that merit special attention. First, audit report qualifications are common, even in respect of major listed companies. Acerete Gil et al, 2002, find that between in the years 1996-2000 the number of qualified audit opinions in the financial statements of listed Spanish companies fell but the number was still high in 2000 when 92 companies had audit qualifications. The Comisión Nacional del Mercado de Valores (the Spanish equivalent of the Securities and Exchange Commission – CNMV) reports that in 2002 109 listed companies have filed financial statements containing a qualified audit report (this figure represents 16.1% of the total number – 676 – of listed company filings). The number of audit report qualifications had, in fact, increased by 15.9% over the comparable figure in 2001.

Second, a feature which is likely to elicit some surprise outside Spain, an element of earnings management may be carried out with the collusion of the regulatory authorities. Supervising agencies\(^{10}\) may permit individual companies to adopt an accounting policy which contravenes current accounting regulation. Such authorisations are provided as a result of effective lobbying by either a company or representative companies within an industrial sector. Successful lobbying of this type demonstrates the power of influence that the business sector may have over government or its agencies. For example, the Spanish Central Bank has occasionally authorised a bank experiencing commercial difficulties, to disapply GAAP relating to provisions for bad debts. Also, during times of currency devaluation, the Spanish accounting regulatory body (ICAC) authorised certain companies (for example, utilities) to derecognise exchange losses. The practice of charging expenses to reserves rather than to the income statement may also be permitted.

Several leading Spanish authorities have recently expressed their view that major accounting scandals, of the type that have occurred in the last two or three years in the USA, are unlikely to occur in Spain. However, this view can be challenged. Jimenez and Abril (2002) have identified several instances of Spanish listed companies with significant accounting problems. For example:

a) Failing to account fully for the consequences of serious risks, especially those arising from exposure in Latin America (e.g. Teléfonica, Teléfonica Móviles, Repsol, Aguas de Barcelona and Aurea).

b) Charging expenses to reserves (BBVA and BSCH)

c) Overstatement of net income (Sol Meliá and Campofrio)

d) Classification of extraordinary profits as income arising from ordinary activities (Unión Fenosa)

e) Failure to provide full information resulting in a limitation of audit scope (Pescanova, EADS, Avanzit, Funespaña and Urbas).

\(^{10}\) These include: the Instituto de Contabilidad y Auditoría de Cuentas (Spanish Institute of Accounting and Auditing – ICAC), the Comisión Nacional del Mercado de Valores (the Spanish equivalent of the Securities and Exchange Commission – CNMV) and the Spanish Central Bank.
Regulatory agencies responsible for policing the implementation of accounting regulation are often accused in Spain of deliberately ignoring obvious cases of rule infringement (for example, see Pérez, 2002).

**Research objective**

The objective of this research is to identify earnings management practices in large Spanish listed companies and to quantify, as far as possible, the effects of such practices using the companies’ financial statements as sources of data. It should be noted that, therefore, any earnings management behaviour identified in the study is relatively overt, and almost certainly legal. The scope of the study therefore excludes all those categories of earnings management behaviour that are hidden and cannot be discerned by an informed and skilled observer undertaking a close examination of the financial statements.

**Research method**

The following occurrences have been classified for the purposes of this study as possible indicators of earnings management:

a) Auditor report qualifications (in Spain there is no requirement to restate the financial statements to reflect the effect of the qualifications. The effect is, however, noted in the audit report).

b) Special authorisations from regulatory agencies to adopt non-standard policy

c) Changes in accounting policy from one year to another (in Spain, such changes have to be explained and the consequences quantified in the auditor’s report).

d) Existence of extraordinary results and prior period adjustments in the income statement

Generally, empirical research on the extent and incidence of earnings management relies upon statistical analysis of, for example, discretionary accruals over a very large dataset (Schipper, 1989). However, the incidence of special accounting features particular to the Spanish accounting environment allows for targeted analysis of individual companies.

The sample of companies comprises the 35 companies included in the Madrid Stock Exchange’s IBEX-35 index. These are the largest companies in Spain and are likely to account for a significant proportion of the total movement of funds in and out of the Spanish capital market. The annual reports of the 35 companies were thoroughly scrutinised over a three year period from 1999 to 2001 in order to identify instances of the four possible indicators of earnings management. The incidence and impact of special authorisations, audit report qualifications and extraordinary items are easy to identify in an annual report. Analysis of any changes in accounting policy are also easy to identify (from information included in the audit report) but require careful
consideration as to whether or not they are likely to constitute earnings management behaviour. Audit report information was considered in conjunction with detailed analysis of the notes to the financial statements in determining whether or not the changes in policy could be categorised as earnings management behaviour.

Accounting policies were compared both with those policies adopted in previous years, and with those adopted by competitors in order to assess whether or not an individual company’s policies were out of line with those generally adopted in the rest of the sector.

Results

The analysis of the results is presented in three sections. First, we consider the effects of the four categories indicating possible earnings management behaviour upon consolidated earnings levels. Then, we examine the effect at the individual accounts level (the financial statements of the holding companies). In both cases, the analysis is of the 2001 financial statements. Finally, we examine the effects on reported earnings at the individual company level, of audit report qualifications, special authorisations and changes in accounting policy in three consecutive years from 1999-2001.

The analysis covers the reported earnings at both the consolidated and individual financial statement level because both sets of financial statements are published in Spain. Users could be influenced by either or both sets, and so it would be potentially misleading to examine only one or the other.

The analysis separates the effects of, on the one hand, audit report qualifications, special authorisations and changes in accounting policy, and, on the other hand, extraordinary items. This is because the first three categories point much more clearly towards earnings management behaviour. The existence of extraordinary items, however, is more ambiguous; they may indicate an attempt at classificatory smoothing, but may be quite genuinely extraordinary (within the definition offered by Spanish accounting regulation). It is beyond the scope of this paper to examine the nature of the extraordinary items but their effect on net earnings is reported here as being worthy of note for two principal reasons:

- The sheer incidence of extraordinary items in the financial statements reviewed.
- The preponderance of extraordinary expenses compared to extraordinary income.

Table 2 shows the effects of all four categories of potential earnings management behaviour on the consolidated financial statements of the IBEX-35 companies. The upper part of the table identifies the effects of audit report qualifications, special authorisations and changes in accounting policy. The financial statements of twelve of the 35 groups of companies (over one-third) contained at least one instance of these effects, and in two cases (BBVA and BSCH —both banks— there were two instances). The lower part of the table demonstrates the level and effect of extraordinary income and expenses on the reporting earnings.
Table 2: Effects of auditors’ qualifications, changes in accounting policy, special authorisations and extraordinary items on net earnings of IBEX 35 (consolidated financial statements in million euros)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net reported earnings A</td>
<td>138</td>
<td>2,363</td>
<td>2,486</td>
<td>241</td>
<td>62</td>
<td>571</td>
<td>565</td>
<td>77</td>
<td>91</td>
<td>59</td>
<td>7,264</td>
<td>8,203</td>
<td>15,467</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditor qualifications B</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment adjustment charged against retained earnings</td>
<td>-67</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill amortisation charged against retained earnings</td>
<td></td>
<td>-11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accelerated goodwill amortisation</td>
<td>64</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill accelerated amortisation charged against retained earnings</td>
<td></td>
<td>8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special authorisations C</td>
<td>-479</td>
<td>-696</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in accounting policy specified in the notes D</td>
<td>-4</td>
<td>-4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>See note 1 below</td>
<td>18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>See note 2 below</td>
<td>44</td>
<td>8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>See note 3 below</td>
<td>52</td>
<td>52</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal E = A +/- B +/- C +/- D</td>
<td>71</td>
<td>1,948</td>
<td>1,834</td>
<td>388</td>
<td>249</td>
<td>249</td>
<td>293</td>
<td>51</td>
<td>466</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
<td>98</td>
</tr>
<tr>
<td>%age change in net earnings = ( \frac{E - A}{A} \times 100 )</td>
<td>-49%</td>
<td>-18%</td>
<td>-26%</td>
<td>+5%</td>
<td>+3%</td>
<td>-18%</td>
<td>-1%</td>
<td>-18%</td>
<td>+27%</td>
<td>-4%</td>
<td>-615%</td>
<td>-22%</td>
<td>0%</td>
<td>-10%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extraordinary expenses G</td>
<td>52</td>
<td>2,021</td>
<td>2,944</td>
<td>130</td>
<td>93</td>
<td>32</td>
<td>30</td>
<td>146</td>
<td>47</td>
<td>2</td>
<td>14</td>
<td>5,491</td>
<td>3,807</td>
<td>9,298</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjusted net earnings H = E + F + G</td>
<td>84</td>
<td>2,674</td>
<td>1,772</td>
<td>248</td>
<td>259</td>
<td>213</td>
<td>66</td>
<td>466</td>
<td>579</td>
<td>106</td>
<td>81</td>
<td>309</td>
<td>6,238</td>
<td>8,541</td>
<td>14,779</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>%age change in net earnings after adjusting for extraordinary items = ( \frac{H - A}{A} \times 100 )</td>
<td>-39%</td>
<td>+13%</td>
<td>-29%</td>
<td>-33%</td>
<td>+7%</td>
<td>-12%</td>
<td>+6%</td>
<td>-19%</td>
<td>+2%</td>
<td>+38%</td>
<td>-11%</td>
<td>-624%</td>
<td>-14%</td>
<td>+4%</td>
<td>-4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note 1: Accelerated depreciation on assets permitted by Real Decreto-Ley 3/1993
Note 2: Treatment of extraordinary and non-recurrent pension plan contributions
Note 3: Capitalisation of interest relating to long-term construction projects
Three of the twelve named groups of companies had been granted special authorisations (all are banking institutions). Six out of the twelve had qualified audit reports; the nature of the qualification is briefly summarised in the table. Five of the groups of companies reported changes in accounting policy that can be construed as potential earnings management behaviour.

Taking these three categories of item into account, consolidated net earnings of the twelve named groups are reduced by 22%. The impact on the aggregated consolidated earnings of the IBEX-35 for 2001 is a reduction of 10%.

Table 3 shows the effects on earnings reported in individual (holding company) financial statements. Two companies experienced auditor qualifications, three had special authorisations and five had changes in accounting policy suggestive of earnings management. The reasons for the specific audit report qualifications and the nature of the accounting policy changes are specified within the table. Adjusted earnings for the nine companies are some 22% lower than reported earnings once the effects of these adjustments are taken into account. The effect of extraordinary items is striking; at the individual company level extraordinary expenses are far higher than extraordinary income.

Finally, the impact of earnings management on reported earnings (at the individual company level only) was assessed for each of the three financial years in the 1999-2001 period. The aggregate impact on earnings of three categories (audit report qualifications, special authorisations and changes in accounting policy) was assessed and an adjusted net earnings figure was calculated. (Note that, for this purpose, and for the reasons explained earlier, extraordinary items were excluded from the analysis). The difference between reported and adjusted net earnings is expressed as a percentage for each of the companies concerned in Table 4.

It may be noted that in 1999, a year when the economy was in a relatively buoyant condition, the reported earnings of 9 firms were less than adjusted earnings. However, in 2000 and 2001 when the Spanish economy was affected by an economic downturn, the position is reversed. A clear majority of the companies under scrutiny in both years showed reported earnings higher than adjusted earnings.

Discussion

All of the earnings management behaviours identified in this study have been identified through careful analysis of the financial statements. Some of the manifestations are easier to identify than others, but all should be observable by a reasonably well-informed user of the financial statements. The question may be asked if the earnings management behaviour is so obvious, can it properly be classified as earnings management at all? However, the extent to which users of the statements actually do observe such relatively clear examples of earnings management is uncertain. It has

11. It is interesting in this context to note that, when an earlier version of this paper was reported in the press in Spain, some of the named companies responded very indignantly to their identification as managers of earnings. This may, of course, be a natural reaction common with any type of adverse publicity, but it could also indicate that company managers do not wish to have the nature and extent of earnings management made public, and suggests the possibility that they may regard it as information that has hitherto been hidden.
Table 3: Effects of auditors’ qualifications, changes in accounting policy, special authorisations and extraordinary items on net earnings of IBEX 35 (individual financial statements in millions of euros)

<table>
<thead>
<tr>
<th></th>
<th>Acciona</th>
<th>BBVA</th>
<th>BSCH</th>
<th>Carrefour</th>
<th>Dragados</th>
<th>Gamesa</th>
<th>Gas Natural</th>
<th>Popular</th>
<th>Red electrica</th>
<th>Sub total</th>
<th>26 other</th>
<th>IBEX 35</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net reported earnings A</td>
<td>65</td>
<td>1,312</td>
<td>1,330</td>
<td>283</td>
<td>93</td>
<td>7</td>
<td>661</td>
<td>447</td>
<td>91</td>
<td>4,289</td>
<td>2,701</td>
<td>6,990</td>
<td></td>
</tr>
<tr>
<td>Auditor qualifications B</td>
<td></td>
<td>–71</td>
<td>–71</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment adjustment charged against retained earnings</td>
<td>–60</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill amortisation charged against retained earnings</td>
<td></td>
<td></td>
<td>–11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special authorisations C</td>
<td>–472</td>
<td>–417</td>
<td></td>
<td></td>
<td></td>
<td>–59</td>
<td>–948</td>
<td>–948</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in accounting policy specified in the notes D</td>
<td>58</td>
<td>18</td>
<td>44</td>
<td>8</td>
<td></td>
<td>58</td>
<td>–4</td>
<td></td>
<td>3,328</td>
<td>2,697</td>
<td>6,025</td>
<td></td>
<td></td>
</tr>
<tr>
<td>See note 1 below</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>See note 2 below</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>See note 3 below</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal E = A +/– B +/– C +/– D</td>
<td>5</td>
<td>840</td>
<td>957</td>
<td>301</td>
<td>101</td>
<td>–4</td>
<td>653</td>
<td>388</td>
<td>87</td>
<td>3,328</td>
<td>2,697</td>
<td>6,025</td>
<td></td>
</tr>
<tr>
<td>Percentage change in net earnings = ( \frac{E - A}{A} \times 100 )</td>
<td>–92%</td>
<td>–36%</td>
<td>–28%</td>
<td>+6%</td>
<td>+9%</td>
<td>–153%</td>
<td>1%</td>
<td>–13%</td>
<td>–4%</td>
<td>22%</td>
<td>0%</td>
<td>–14%</td>
<td></td>
</tr>
<tr>
<td>Extraordinary expenses G</td>
<td>31</td>
<td>536</td>
<td>1,959</td>
<td>154</td>
<td>44</td>
<td>14</td>
<td>52</td>
<td>99</td>
<td>15</td>
<td>2,904</td>
<td>5,353</td>
<td>8,257</td>
<td></td>
</tr>
<tr>
<td>Adjusted net earnings H = E + F + G</td>
<td>36</td>
<td>377</td>
<td>1,161</td>
<td>240</td>
<td>113</td>
<td>0</td>
<td>638</td>
<td>464</td>
<td>94</td>
<td>3,123</td>
<td>7,486</td>
<td>10,609</td>
<td></td>
</tr>
<tr>
<td>Percentage change in net earnings after adjusting for extraordinary items = ( \frac{H - A}{A} \times 100 )</td>
<td>–45%</td>
<td>–71%</td>
<td>–13%</td>
<td>–15%</td>
<td>+22%</td>
<td>–100%</td>
<td>–3%</td>
<td>+4%</td>
<td>+3%</td>
<td>+27%</td>
<td>+177%</td>
<td>+52%</td>
<td></td>
</tr>
</tbody>
</table>

Note 1: Accelerated depreciation on assets permitted by Real Decreto-Ley 3/1993
Note 2: Treatment of extraordinary and non-recurrent pension plan contributions
Note 3: Capitalisation of interest relating to long-term construction projects
been observed that analysts’ reports in Spain usually fail to mention the existence of audit report qualifications, special authorisations or other manifestations of earnings management practices, and that analysts have very short memories where such matters are concerned (Expansión Directo, 2002). Even quite clear signalling can be misinterpreted or ignored even by relatively sophisticated users (Beton and Taffler, 1995). Furthermore, Dechow and Skinner (2000) argue that even if financial statements provide sufficient information to permit users to adjust for earnings management, there would still be cause for concern over the value of the information content because of ‘the possibility that certain investors rely completely on earnings numbers reported on the face of the income statement because their ability to process more sophisticated (i.e. footnote) information is limited’.

The results of the research show that some element of overt earnings management practice is common in large Spanish companies. The unusually high incidence of audit report qualifications identified by Acerete Gil et al. (2002) and the CNMV suggests that corporate management commonly takes the decision to overstate or understate net earnings even at the expense of a report qualification. In some cases, this may be because managers genuinely feel that their own presen-

<table>
<thead>
<tr>
<th>Company</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acciona</td>
<td></td>
<td></td>
<td>−92%</td>
</tr>
<tr>
<td>Acerinox</td>
<td>+3%</td>
<td>+1%</td>
<td></td>
</tr>
<tr>
<td>Alba</td>
<td></td>
<td></td>
<td>+2%</td>
</tr>
<tr>
<td>Acesa</td>
<td>−3%</td>
<td>−3%</td>
<td></td>
</tr>
<tr>
<td>BBVA</td>
<td>−14%</td>
<td>−58%</td>
<td>−36%</td>
</tr>
<tr>
<td>BSCH</td>
<td>−74%</td>
<td>−44%</td>
<td>−28%</td>
</tr>
<tr>
<td>Bankinter</td>
<td>+2%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carrefour</td>
<td>+11%</td>
<td>+7%</td>
<td>+6%</td>
</tr>
<tr>
<td>Dragados</td>
<td>+13%</td>
<td>−10%</td>
<td>+9%</td>
</tr>
<tr>
<td>Endesa</td>
<td>+2%</td>
<td>−219%</td>
<td></td>
</tr>
<tr>
<td>Gasesa</td>
<td>−952%</td>
<td>−153%</td>
<td></td>
</tr>
<tr>
<td>Gas Natural</td>
<td></td>
<td></td>
<td>−1%</td>
</tr>
<tr>
<td>Iberdrola</td>
<td>−21%</td>
<td>−74%</td>
<td></td>
</tr>
<tr>
<td>Indra</td>
<td>+3%</td>
<td></td>
<td>+9%</td>
</tr>
<tr>
<td>Popular</td>
<td></td>
<td></td>
<td>−13%</td>
</tr>
<tr>
<td>Prisa</td>
<td></td>
<td>+14%</td>
<td></td>
</tr>
<tr>
<td>Red Eléctrica</td>
<td>−2%</td>
<td>−3%</td>
<td>−4%</td>
</tr>
<tr>
<td>Sol Meliá</td>
<td></td>
<td>−73%</td>
<td></td>
</tr>
<tr>
<td>Telepizza</td>
<td></td>
<td>−252%</td>
<td></td>
</tr>
<tr>
<td>Telefónica</td>
<td>+10%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unión Fenosa</td>
<td>+37%</td>
<td>−15%</td>
<td></td>
</tr>
</tbody>
</table>

Number of companies 14 16 9
Reported earnings > adjusted 5 11 7
Reported earnings < adjusted 9 85 2
tation provides a fairer view. However, it appears in practice that many audit report qualifications relate simply to disagreement over the adequacy of discretionary accruals elements.

The results of the study over a three year time period suggest that the direction of earnings management could be related to general economic conditions. (This possibility was flagged by Merchant (1990)).

In 2005, Spanish listed companies, in common with all others in the European Union, will be obliged to report under international accounting standards. A decision has been taken in Spain to extend this reporting requirement to all unlisted companies by 2007; therefore, de facto, Spanish accounting regulation will cease to exist within a very short period of years. However, it appears that Spanish corporate managers are accustomed to (often) large-scale accounting manipulation, and the change of regulatory regime may not necessarily alter behaviour. As demonstrated in this study regulatory agencies were quite prepared to offer dispensations from compliance to effective lobbyists in 2001; it may be reasonable to suppose that lobbying in the Spanish environment will continue to produce successful outcomes for the lobbyists.

Conclusions, limitations and suggestions for further research

This paper has quantified the extent of certain types of earnings management upon the largest Spanish companies. The availability and potential impact of special authorisations to avoid certain regulatory provisions is likely to be of particular interest to a non-Spanish readership. However, the high incidence of audit report qualifications is also a feature of interest, as is the nature of the accounting policy changes practised in the period under review. It can be concluded that relatively overt forms of earnings management do take place amongst several leading Spanish listed companies. Companies take advantage of the range of accounting policy options permissible within the regulations to manipulate their reported earnings. The nature and extent of this phenomenon should be of interest to the Spanish regulatory authorities.

From a policy perspective, it would appear to make sense to reduce the number of options available in Spanish accounting. This would be in line with the approach adopted by the International Accounting Standards Board, and would better prepare Spanish companies for the changeover to international standards that will take place in the next few years. However, tightening the rules is not, on its own, sufficient. As observed earlier in the paper, improving standards in one area simply tends to shift the location of earnings management. In Spain, remedial measures must also include improvements in accounting supervision. On a sub-regulatory level, analysts could be encouraged to include more information in their reports on overt earnings management practices.

The study reported in this paper has some clear limitations. One of its principal limitations is that the analysis has been limited to only those earnings management practices that can be identified easily from published financial statements. From an agency theoretical perspective, it might be expected that managers would attempt, as far as possible, to conceal such practice; the condition of information asymmetry means that they are well placed to do so. Agency theory suggests
that we might expect, with a reasonable degree of confidence, that deliberately concealed earnings management also takes place.

A further limitation should be recognised in respect of the sample of companies chosen for examination. While the IBEX-35 companies are certainly highly significant to the Spanish economy, they may not be representative of it. On the one hand, they are more profoundly affected by developments and improvements in corporate governance, but on the other hand, they are under greater pressure from analysts than smaller companies to report within certain parameters.

The study suggests opportunities for further research. First, within the limitations established in the paper, it would be possible to extend the analysis further to cover both a longer time period and a larger number of companies. Further research of the type pioneered in the USA by, for example, McNichols and Wilson (1988) applying discretionary accruals models to large financial data sets in order to identify the extent of covert earnings management, could be undertaken in Spain. It is clear from the evidence presented in the paper that extraordinary items are frequently encountered features in Spanish published financial statements. This paper has not, however, attempted detailed analysis of such items, and it is likely to be a fruitful area for future research. Finally, the impact upon Spanish analysts and other key users of the relatively overt earnings management behaviour discussed in this paper is under-explored. Further research is needed to identify the extent to which users of Spanish listed companies’ financial statements are capable, in practice, of identifying the earnings management features discussed in this paper.

References


