

Determinants of the decision-taking process of the entry into insolvency, evolution of the procedure and earnings management: An economic perspective of Spanish distressed companies

Andreev Andreev, Yuriy

Abstract

The purpose of the study is to determine the influence of short-term liabilities on debtor's earnings management and bankruptcy resolution and to explore the evolution and the efficiency of the insolvency procedure. Tirole (2002) allege that "over-borrowing" or "over-lending" leads to common agency problems and that the contractual externalities related to it guide to inefficient lending. This result in excessively short-term debt that affects firm's liquidity and jeopardizes its long-term projects, and in bankruptcy situation prevent efficient roll-over and restructuring. The successful reorganization procedure is also determined by elevated proportion of tangible assets, high reputation and size, and maintaining the control over company's management during the insolvency period. The bankruptcy procedure in Spain continues about two and half years, depending on the size, region, and the availability of reorganizational proposal. The prompt creditors' redemption is fundamental for the efficiency of the procedure and the confidence and credibility of system. The insolvent firms proved to have negative discretionary accruals for various accounting periods, which taken into account their high leverage means they use earnings management techniques to convince creditors in their solvency situation. The discretionary accruals have been found to be significant determinants of creditors' decision to approve the proposed restructuring plan - those firms that initiate reorganization provide evidence that employ less earnings management techniques. The main contribution of the research is the finding that the insolvent firms engage in earnings management to avoid debt covenant default due to their excessive level of short-term debt. The over-credited short-term structure makes the creditors more exigent towards their liquidity ratios - the primer motive for the application of manipulation techniques.