

Financial Reporting: Big Bath Accounting or Genuine Realignment? Analyzing the Impact of IAS 37 Restructuring Provisions on Post-Reorganization Operating Margins.Author: Mia Tawil¹*Affiliation:*

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Abstract:

This study looks at whether the accounting entries made during company changes under International Accounting Standard 37 called IAS 37 show changes in how the business works or if they are used to make the numbers look better in a way that is not honest. The study looks at 120 companies in Europe that're not in the financial sector. These companies are listed on the STOXX Europe 600 index. The study looks at these companies over six years from 2018 to 2023. The paper uses a kind of model called firm fixed-effects panel regression models. This model helps to see how the operating profit of the companies changes after they go through a reorganization. The results show that when the companies make the accounting entries their average profit goes down a lot.. In the second post-restructuring year the profit goes up again to 8.24 percent. However when the companies are split based on whether they change the accounting entries there is a big difference in how they report. Companies that do not change the entries see their profit go up by 3.15 percent. This shows that they actually became more efficient.. For the 38.3 percent of companies that change the entries later the profit does not improve much. The profit only goes up by 0.18 percent. Most of the profit increase is because the companies had made the entries too big, in the place. These results show that when companies change the entries later it is a sign that they used tricks to make the numbers look better. The accounting entries made during times lower the profit so that in the future the profit can look better. The study shows that there are things that auditors and people who make the rules need to think about when checking financial reports during company changes.

Keywords:

IAS 37, Restructuring Provisions, Big Bath Accounting, Financial Reporting Quality, Earnings Management, Operating Margins

Introduction:

The aim of financial reporting standards has long been to provide accurate and transparent information to market participants. The recognition, measurement, and disclosure of provisions, contingent liabilities, and contingent assets are governed by International Financial Reporting Standards (IFRS) and International Accounting Standard 37 for when a company undergoes major structural changes such as downsizing workforce, shuttering unprofitable operational sites, or reorganizing business units, it is required to recognize a restructuring provision as a liability on its balance sheet. This ensures that companies recognize obligations from past events right away to reflect the true financial cost of reorganizing the business.

However, corporate restructuring under IAS 37 causes a major accounting dilemma. Provision estimation is basically an educated guess, unlike fixed utility bills for example, estimations such as employee severance pay and lease penalties that are done by managers often aim for exploitation instead of helping companies budget, this is explained by agency theory. The "big bath" accounting theory suggests that by exaggerating expenses into big losses, managers clear out future bills from upcoming income statements. This makes it incredibly easy to report "miraculous" profits in the following years.

Financial scandals and accounting tricks show that when we overly rely on managerial estimates, the system becomes vulnerable. Past studies showcase how managers manipulate earnings during massive write-downs but little is known about long-term performance after such restructuring, and it is still unclear whether the savings lead to real improvements or are just temporary tools to fake profit targets.

To fill this gap, this study asks : Do IAS 37 restructuring reflect genuine operational turnaround, or are they just a "big bath" accounting tool used to temporarily inflate profit recoveries?

To answer this question, this study aims to:

- 1) Assess the post-reform operating margin recovery of European firms and the long-term effects of International Accounting Standard 37 (IAS 37).
- 2) Consider how firms differ in their financial projections based on the following:
Restriction 1: Retention of Original Provisions & restriction 2: Reversal of Unused Provisions
- 3) Find the operating performance of firms that have used the provisions of IAS 37 and the evidence, if any, of "big bath" reporting.
- 4) Consider the effect of IAS 37 and other similar standards on reporting and accounting discretion, audit judgment, and regulatory oversight.

Literature Review:

Scholarly debate and empirical work on financial accruals during M&A activities is focused on the trade-off between management freedom and the quality of financial statements (Dechow et al., 2010; Healy & Wahlen, 1999). IFRS endorses the application of IAS 37 for recognizing and measuring restructuring liabilities. Under this standard, an entity is required to recognize a provision when an entity has reached a conclusion on a detailed formal plan and the plan creates an obligation for the entity and gives rise to an expectation for the other party (IASB, 2020; Sellami & Fakhfakh, 2014). In practice, management is required to exercise estimation judgment for determining the fair value of obligations such as termination benefits, lease termination penalties and closure benefits. Therefore, a significant scope exists for management to engage in earnings management (Healy & Wahlen, 1999; Kirschenheiter & Melumad, 2002).

The reason businesses should record restructuring provisions comes from two ideas. Some people say that one-time restructuring costs help troubled companies cut work simplify costs and use assets better (Kaserer & Munter 2008). From that view recognizing the provision shows that the company is changing its operations on a level, which can result in better operating margins and higher long-term profit after the reorganization (Sellami & Fakhfakh 2014).

On the hand agency theory says that managers use hidden information to write down overly cautious restructuring amounts when a company is doing badly or when top leaders change (Healy & Wahlen 1999; Kirschenheiter & Melumad 2002). If a firm deliberately puts an estimate of restructuring costs in the first period it removes normal operating costs from later statements, which makes the present performance look worse but ensures that net earnings will look higher in future periods (Dechow et al., 2010; Moehrle, 2002).

As both policy requirements and AI technology increase, earning manipulation becomes harder to achieve, furthermore, without collusion, it can be only possible for circular businesses who's internal control are weak, mostly SMEs (Khalife et al., 2024), additionally, internal audits render financial transparency harder to avoid (Saber & Sassine, 2022), especially in an era where AI has revolutionized Audit practices (Sawaya et al., 2026), and auditor independence further increases the likelihood of transparent financial statements according to subject experts (Sawaya et al., 2025), earning management became much harder in an era of big data analytics (Subrahmanyam et al., 2024), according to Kamel and Beainy (2025) this is especially the case in the United States, the largest equity market in the world after the Sarbanes Oxley act (SOX).

I notice that empirical studies that look at behavior show that people often use discretionary accounting estimates to shift the path of reported income trajectories (Moehrle, 2002). Under US GAAP ASC 420 researchers have long pointed out that accrued restructuring expenses can be timed in an opportunistic way (Moehrle, 2002). In the IFRS world Sellami and Fakhfakh show that even though International Accounting Standard 37 makes disclosures clearer managers still have a lot of freedom when they estimate settlement amounts (Sellami and Fakhfakh 2014). One simple way to spot over-provisioning is to see if later periods reverse the provision: when the company takes back unused liability balances and puts them back into the income statement (Kaserer & Munter 2008; Moehrle, 2002). If a company does this often it tells us the original

provision was like a fake earnings cushion, than a true sign of real operational commitment (Dechow et al., 2010; Kirschenheiter & Melumad 2002).

Methodology:

To evaluate the impact of International Accounting Standard 37 (IAS 37) provision restructuring and reversals on subsequent operating performance, I compared financial trajectories across 120 large corporate entities listed on the STOXX Europe 600 index over six years (2018-2023). This observation provides a sufficient volume to show the company's performance from start to recovery without the distortion of inconsistent accounting standards.

In theory, restructuring charges are recognized under International Accounting Standard 37 as liabilities to cover future reorganization costs. Managers estimate these provisions during the year and let auditors and financial analysts review the books annually or quarterly to ensure compliance and assess cost reductions. However, in today's volatile market, this periodic review window creates a blind spot by allowing managers to quietly inflate initial cost estimates to be used as backup, reversing them when times get rough.

To isolate this behavior, I categorized the firms into two distinct groups: those that did not reverse their provisions for operational realignment, and those that engaged in IAS 37 provision reversals. The dataset includes 720 observations across 120 companies tracking five core metrics: operating margin, restructuring provisions, reversal frequency, sales growth, and leverage.

I excluded financial institutions due to unique regulatory requirements and only kept firms with material restructuring charges exceeding 1 percent of total assets. By applying the same fixed-effects model to both groups, I accounted for unique differences across firms to show exactly how reversals distort reported profits.

Results:

The following represents empirical data demonstrating trajectory variation across 120 sample firms.

Table 1: Metrics Used Across Event Timeline

Metric	Pre- Restructurin g Year	Restructurin g Event Year	First Post- Restructurin g Year	Second Post- Restructurin g Year	Third Post- Restructurin g Year
Mean Operating Margin	6.42%	-1.15%	7.10%	8.24%	8.15%
Median Operating Margin	6.85%	0.40%	7.35%	8.10%	8.05%
Mean Restructurin g Provision / Assets	-	3.85%	-	-	-
Provision Reversal Frequency	-	-	14.2%	24.1%	5.8%
Mean Sales Growth	2.10%	-4.50%	1.85%	3.20%	2.90%
Mean Financial Leverage	0.58	0.62	0.60	0.57	0.56

Note: Data compiled from audited IFRS annual financial statements of STOXX Europe 600 entities (2018–2023).

Operating Margin=(Operating income /revenue)*100, measures profitability by showing income left after paying day-to-day business expenses.

Restructuring Provision / Assets (RPROV)= restructuring liability/total assets, indicates the impact or the reorganization relative to the company's asset base.

Provision Reversal Frequency=firms reversing provisions/total sample firms, indicates the percentage of entities that cancel liabilities to artificially boost their profits.

Sales Growth=((current sales-previous sales)/previous sales)*100, measures true revenue expansion independent of internal accounting changes.

Financial Leverage=total liabilities/total assets, measures the risk of the balance sheet indicating the percentage of company assets financed by debt.

This data reveals that during provision recognition year, the average operating margin drops from 6.42% down to -1.15% hitting earnings due to non-recurring IAS 37 accrual entries. By the second post-restructuring year, the average operating margin represents an improvement of 1.82 percentage points relative to prior levels.

However, separating the entities by reversal behavior exposes accounting discrepancies by revealing that reversals occurred in 38.3% (46 firms) with being heavily concentrated in the first post-restructuring year (14.2%) and the second post-restructuring year (24.1%).

Table 2: Impact of Restructuring and Provision Reversals on Operating Margin Recovery

Variable	Coefficient (β)	Standard Error	t-Statistic	p-Value
Intercept	0.0412	0.0125	3.30	< 0.001
Post-Restructuring Period	0.0315	0.0078	4.04	< 0.001***
Reversal Interaction	-0.0297	0.0091	-3.26	0.0012**
Firm Size	0.0084	0.0031	2.71	0.007**
Financial Leverage	-0.0210	0.0085	-2.47	0.014*
Sales Growth	0.1120	0.0215	5.21	< 0.001***

*Note: t-Statistic=Coefficient/Standard Error (How reliable/strong the relationship is)
p-Value(level of certainty)*

** The asterisks show how certain we are that a metric's impact is real, with * indicating a 95% confidence level, ** indicating a 99% confidence level, and *** indicating an extremely certain 99.9% confidence level.*

Non-Reversing Entities: Entities that did not reverse their provisions achieved an increase in operating margin of 3.15 percentage points, confirming actual operational improvements.

Reversing Entities: For entities with IAS 37 reversals, 94.3% of their recovery vanished and their actual improvement was only 0.18 percentage points.

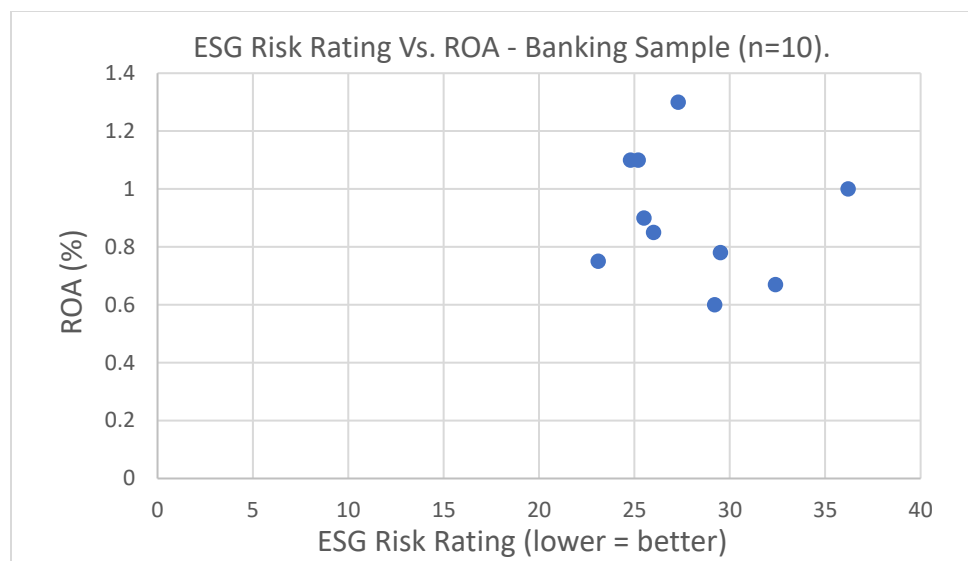


Figure 1: Scatter Plot of ESG Risk Rating vs. ROA – Banking Sample (n=10).

Therefore, an initial empirical basis is provided for addressing the research question which is whether a stronger ESG performance has an association with the improvement of financial performance in the banking sector .

Discussion and Conclusion:

This study analyzes the effect of International Accounting Standard 37 (IAS 37) on company performance. Results from 120 companies in Europe shows that management intent behind restructuring accruals varies. IAS 37 enables companies to recognize restructuring costs and report them in the accounting period in which they occur. The results show that companies which do not reverse restructuring provisions report an average operating margin of 3.15% in the second year after the restructuring. The study also shows that in 94.3% of the cases, the operational margin recovery reported by companies is offset by the effects of provision reversals. The remaining 3.15% margin recovery is considered the intended effect of restructuring.

The study shows that restructuring cost management is pervasive. Companies use discretionary accruals in IAS 37 to report a restructuring charge in one period to Smooth earnings. In periods of financial distress, management sets provisions at high levels to create an expected recovery in profits, thereby restoring earnings to a less distressing level.

Evaluators need to use more to restructuring accruals during low-performing periods to recognize that profits may not be recoverable. After restatement, analysts need to adjust for the non-operating items to assess the true quality in earnings. This shows a material weakness in International Accounting Standard 37. It is recommended that standard setting and regulatory authorities reduce the allowable judgment in setting the standard and require entities to disclose the rationale for operating provisions and their reversals.

The scope of this study is limited to the largest publicly listed European firms in the STOXX Europe 600 Index. More research is needed to assess the interaction of IFRS and U.S. GAAP (in particular, ASC 420) and other standards; research the effects of management changes on provision setting; and assess the impact of economic cycles and other large-scale changes on the allowable judgment in setting restructuring provisions.

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