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ACCEPTED MANUSCRIPT

Examining the relationship between Earning management and market liquidity

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Abstract:

The main purpose of this paper is to argue the extent that earnings management lowers liquidity. It should increase information asymmetry and impair trading liquidity. Using a sample of French firms from 2008 to 2011, we find that firms that manage earnings have wider bid-ask spreads. Our results are robust for both of two well-established measures of market liquidity. Therefore, the empirical results indicate that firms that exhibit greater earnings management are associated with lower market liquidity. These findings are in line with adverse selection and shed light on the role corporate governance devices can play in the consideration of shareholder interest's protection, which leads to improved stock market liquidity levels.

Keywords: Earnings management, Bid-ask spreads, stock liquidity, discretionary accruals

1. Introduction

Healy & Palepu (2001) suggest that the cascade of financier and accountant scandals that marked the beginning of this decade has shed light on the role of transparent and clear information in maintaining a well operate financial market. The concept of Market liquidity is highly dependent on informational transparency. High liquidity allows companies to raise additional funds on favourable terms through low transaction costs and no time lag between economic agents (Stoll, 1978; Glosten & Milgrom, 1985). The presence of information asymmetry in the market may reduce liquidity (Jacoby *et al.* 2000).

Therefore, liquidity forms a very timely issue that is gaining a growing interest. This issue is correlated with an increased focus on the issue of quality of information. This focus presently dates back a number of years, but in recent years, and following multiple scandals (WorldCom , Enron , Vivendi, Parmalat ...) the subject has become topical again. Since the resurgence of interest, several reform initiatives have been made (Sarbanes -Oxley in the United States, financial security law in France) and the adoption of IFRS which has been adjusted from 2005 accounting standards. These initiatives are part of the process of harmonizing financial reporting at the European level and choosing accounting convergence. The objective is to reduce accounting manipulations and earning management in favour of better financial transparency, which appears as a necessary objective to increase security for investors.

The present work falls within this context. Indeed, we try in this research to study the relationship between the quality of the information disclosed, and particularly the level of earnings management, and the liquidity of companies. The study of this relationship is of considerable interest because of its important implications for both companies and investors. For investors better quality of information allows them to make better choices for their portfolios. They would be reluctant to invest in a company showing a low quality of the result. This finding reveals a practical interest for managers who can take the opportunity to improve their policy disclosure in order to reduce information asymmetries in the market, increase investor confidence and increase the number of transactions for their company.

In theoretical terms, this relationship can be explained by two main hypotheses. The first concerns transactions. It states that the volume of transactions induced by greater transparency enhances liquidity. Indeed, the extent of disclosure attracts investors. They will be encouraged to carry out significant transactions due to a large volume of market orders which would result in lower transaction costs, and hence, better liquidity (Healy & Palepu, 2001). The second hypothesis concerns adverse selection, which states the existence of informational asymmetries in the market reflected by a widened spread. The Signaling through mechanisms of information has as a result a lower adverse selection component of the bid-ask spread and an increase in market liquidity (Glosten & Milgrom, 1985).

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