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Does pedigree matter? Earnings quality of U.S. listed domestic firms via reverse mergers

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ABSTRACT

This paper examines earnings quality of U.S. domestic firms that access capital markets via a reverse merger transaction (RM firms) compared to those via the more traditional initial public offering (IPO firms) during the period from 1997 to 2011. In order to mitigate confounding effects of legal regime, law enforcement, and culture, we require both the acquiring and target firms to be incorporated and headquartered in the U.S. to be included in our sample. We also use the Heckman (1976) procedure to control for self-selection bias. To capture earnings quality, we use a battery of measures established in prior literature, including discretionary accruals, discretionary revenues, real activities earnings management, and accrual estimation errors. Our measures have both convergent and discriminant validity and therefore appear to capture earnings quality fairly well. We find consistent evidence that U.S. domestic RM firms have lower earnings quality compared with U.S. IPO firms. Our evidence suggests that investors and other stakeholders should take into account the fact and consequences of the method that firms use to access capital markets in their investment decision making process.

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1. Introduction

This paper examines the earnings quality of U.S. domestic firms that enter U.S. capital markets via the method of reverse merger (hereafter RM) as compared with the earnings quality of U.S. firms accessing capital markets via initial public offering (IPO). Firms have traditionally accessed capital markets via IPOs; however, the RM is an alternative method for a firm to access capital markets. In an RM, an existing public traded company (typically a shell company[2]) acquires a private company with the acquired private company being the survivor of the merger such that the shareholders of the private company gain a controlling interest in the voting power and outstanding shares of the public company. The private company's investors and management typically obtain a significant proportion of the board of directors and key management positions respectively within the public company (SEC, 2011a). Through this process, the private company actually becomes a public company.

Since 2000 an increasing number of firms have used the RM method to access U.S. capital markets. Feldman and Dresner (2006, p2) report that the number of RMs increased fourfold during the six year period between 2000 (46 cases) and 2005 (179 cases). The PCAOB (2011) also reports that there were 234 RMs in 2007, 182 in 2008, and 141 in 2009.

The use of RM method provides multiple benefits for private companies' entry to capital markets. Two of the primary benefits identified by prior research are lower transaction costs (Gleason et al., 2005; Aydogdu et al., 2007), and shorter timelines to enter capital markets (Arellano-Ostoa and Brusco, 2002). RMs can be a cost-effective way for firms to go public. The cost for an RM transaction is substantially lower than that for an IPO. For example, Gleason et al. (2005) report that the combined fees to the target and the acquirer average 2.72% of the transaction value, while the average gross spreads total 11% for an IPO. Also, the timelines for an RM transaction is much shorter. Arellano-Ostoa and Brusco (2002) report that an RM can take no more than three months compared with six to nine months for an IPO. Some firms use a reverse merger just to avoid the time-consuming process of an IPO (e.g., the U.S. fast food chain Burger King, Darrough et al., 2012).

A third advantage of the RM method is that it is less affected by market conditions while the timing of an IPO can be significantly impacted by unfavorable market conditions, which may lead to lower capital raised and market value, and potential delays in the IPO due to these concerns. For example, Semenenko (2011) finds that small private firms even take advantage of unfavorable market conditions by entering capital markets via RMs with financially distressed shell firms.

Despite these major advantages, prior research has also identified several disadvantages of using the RM method. Sjostrom (2008) argues that RMs are not capital raising transactions, and therefore no additional equity capital is obtained. Furthermore, RMs do not require the company to receive underwriter certification. As a result, the company's stock price may trade at a discount to reflect these factors and the stock's relative illiquidity. Feldman and Dresner (2006) provide a comprehensive discussion of advantages and disadvantages of RMs.

Recently, investors and regulators have raised concerns with the quality of RM firms. For example, a study by Stanford Law School and Cornerstone Research (2011) report that more than one quarter of recent U.S. securities fraud lawsuits seeking class-action status were related to Chinese reverse mergers. They found that 24 securities fraud class-action lawsuits targeted Chinese reverse mergers in the first half of 2011, compared with 9 for all of 2010. The Security and Exchange Commission (SEC) issued an Investor Bulletin (SEC, 2011a) to alert investors of risks involved with RM firms and listed several enforcement actions on RM firms. The PCAOB has also issued a research note identifying auditing concerns with RM firms (PCAOB, 2011), including concerns about understanding local language, the use of local audit firms, and the local business environment. PCAOB (2011) encourages more research in this area by academia, journalists and other interested parties. This paper is a response to that call.

Although there are concerns with the financial reporting quality of RM firms, especially foreign RM firms (e.g., Chinese RM firms), evidence is inconclusive as to whether RM transactions are a cause for increased investor, auditor, and regulatory concern, especially for U.S. domestic RM firms. Anecdotal evidence has shown that reputable U.S. companies entered the capital markets via RM transactions,

[2] A shell company is a public reporting company with few or no operations (SEC, 2011a).

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