



Real earnings management and the cost of new corporate bonds[☆]



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ABSTRACT

We examine the association between real earnings management and the cost of new bond issues of U.S. corporations. We consider three types of real earnings management: sales manipulation, overproduction, and the abnormal reduction of discretionary expenditures. We find that overproduction impairs credit ratings and that sales manipulation and overproduction are associated with higher bond yield spreads. Overall, our results imply that credit rating agencies and bondholders perceive real earnings management as a credit risk-increasing factor and thus require high risk premiums.

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1. Introduction

This paper examines the association between real earnings management (REM) and the cost of new corporate bond issues. Standard & Poor's indicates that earnings and cash flows are important financial factors for assessing a firm's creditworthiness; it also notes that a firm's profitability and ongoing earnings power are critical determinants of credit ratings (S&P, 1998). Consistent with this notion, Khurana and Raman (2003) find the bond market prices earnings-related fundamentals. However, much empirical evidence suggests that earnings management is a common phenomenon. In particular, prior literature documents that raising capital provides incentives

for earnings management because managers tend to inflate earnings to reduce the risk premium (e.g., Bhojraj, Hribar, Picconi, & McInns, 2009; Cohen & Zarowin, 2010; Graham, Harvey, & Rajgopal, 2005). Managers can manage current earnings in two different ways. First, managers can exercise discretion over accrual choices that are allowed under Generally Accepted Accounting Principles to reach a desired level of earnings (referred to as accrual-based earnings management). Second, managers can manage earnings by altering the timing and scale of operating decisions. These actions deviate from normal business practices, with the primary objective of misleading stakeholders on underlying economic performance. Researchers refer to the second type as REM, or real activities management (Cohen & Zarowin, 2010; Mizik & Jacobson, 2008; Roychowdhury, 2006; Zang, 2012).

Earnings management distorts the quality of reported earnings (e.g., Chung, Firth, & Kim, 2005; Hadani, Goranova, & Khan, 2011; Sun, Liu, & Lan, 2011), which can impact bondholders' estimates of future cash flows. Recent research demonstrates that abnormal accruals (a measure of accounting quality or accrual-based earnings management) have a negative impact on the cost of debt (Bharath, Sunder, & Sunder, 2008; Francis, LaFond, Olsson, & Schipper, 2005; Prevost, Rao, & Skousen, 2008). Since these studies focus on the impact of accrual-based earnings management on the interest cost of borrowing, there is little evidence on how investors in the bond market perceive REM. To fill this void, our study investigates whether potential bondholders perceive REM to be a credit risk increasing or decreasing factor. Stated another way, our analysis focuses on the hitherto unexplored question of whether bondholders require higher or lower risk premiums in response to REM.

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Following recent REM studies (e.g., Cohen, Dey, & Lys, 2008; Roychowdhury, 2006), we consider three types of REM activities: (1) sales manipulation, (2) overproduction, and (3) cutting discretionary expenses. Sales manipulation reflects managers' attempts to increase sales during the year by offering "limited-time" price discounts or more lenient credit terms. The escalated sales are likely to disappear once the firm reverts to old prices. In addition, offering more lenient credit terms, such as a longer payment period, increases a firm's risk exposure to uncollectible accounts. Sales manipulation leads to lower current-period operating cash flows for a given level of sales.

Overproduction refers to producing more goods than necessary to increase earnings. The cost of products sold appears as the cost of goods sold (COGS) in the income statement and the cost of products unsold appears as inventory in the balance sheet. By overproduction, the overhead cost spreads over more units of products, which results in lower unit cost. This allows managers to report a lower COGS given sales levels and thus increase reported earnings while leaving a substantial portion of production costs in the inventory account in the balance sheet. Earnings boosted this way are less sustainable and the excessive inventory may turn out to be obsolete so that a loss may occur in the future.

Discretionary expenses often include advertising, employee training, maintenance, and other expenses. Firms generally pay discretionary expenditures by cash. Reducing such expenditures lowers cash outflows and has a positive effect on abnormal cash flows in the current period, possibly at the risk of lower future cash flows. For example, the abnormal reduction of advertising expenses can result in lower future sales revenues and therefore lower future cash flows; an abnormal reduction of employee training expenses can hurt a firm's competitive edge in the long run.

Examining the effect of REM in the bond market is important for several reasons. First, REM appears to be a common practice. For example, the survey of Graham et al. (2005) suggests that 80% of the survey participants, executives of U.S. firms, would rather implement real economic actions that could have long-term adverse consequences than make accounting adjustments to meet short-term earnings targets.

Second, as described earlier, REM deviates from optimal business operations, hides a firm's unmanaged earnings, and can be detrimental to a firm's long-term profitability and competitive advantages (Cohen & Zarowin, 2010; Wang & D'Souza, 2006; Zang, 2012). Therefore, REM increases the information asymmetry between managers and bondholders with respect to a firm's current-period unmanaged earnings performance and thus can affect bondholders' estimates of a firm's ongoing earnings power. This information risk has a potential effect on bond pricing.

Third, bondholders have contractually fixed claims such as periodic interest payments. They tend to focus on future cash flows to ensure a firm's ability to pay interest and bond principal. Because REM can have direct negative consequences on the level of future net cash flows (Graham et al., 2005; Kim & Sohn, forthcoming; Roychowdhury, 2006), bondholders are likely to be concerned about and respond to REM activities.

Fourth, prior studies argue that REM is opaque to outside stakeholders and difficult to detect (Graham et al., 2005; Zang, 2012) because they are not subject to external monitoring and scrutiny by auditors and regulators. It is an open question whether potential bond investors perceive REM as an opportunistic behavior. Our study therefore aims to provide empirical evidence on the impact of REM on new corporate bond offerings in the U.S. market.

2. Related literature and hypothesis development

Creditors use earnings and other accounting information to assess firm health, credibility, and viability (e.g., Ederington & Yawitz, 1987; Fischer & Verrecchia, 1997; Ho & Rao, 1993; Khurana & Raman, 2003; S&P, 1998; West, 1970). However, empirical evidence suggests that

managers tend to manage earnings for their private benefit. Earnings management occurs when managers use discretion in financial reporting or structure transactions to alter financial reports either to mislead some stakeholders about the underlying economic performance of the firm or to influence contractual outcomes that depend on reported accounting numbers (Healy & Wahlen, 1999). Earnings thus become a less reliable measure of firm performance and reported earnings that are pertinent to investor pricing decisions can be of poor quality (Francis et al., 2005).

Bondholders tend to focus on a firm's ability to generate future cash flows to ensure the payment of periodic interest and the bond's principal. The quality of accounting information affects bondholders' estimates of future cash flows. Bharath et al. (2008) find that firms with poorer accounting quality face significantly higher yield spreads of new bond issues. Prevost et al. (2008) report that abnormal accruals have negative price impacts on all bonds. These findings suggest that creditors demand a higher rate for firms managing earnings through accruals.

In addition to accrual-based earnings management, managers can manage earnings through real economic actions. Real earnings management camouflages a firm's current-period unmanaged economic performance. To the extent that these actions deviate from optimal business operations, REM jeopardizes a firm's competitive advantage in the long run (Cohen & Zarowin, 2010; Wang & D'Souza, 2006; Zang, 2012). Manipulated earnings numbers cannot serve as a reliable measure of firm performance for bondholders to assess a firm's future profitability. In this sense, REM distorts earnings quality and increases information asymmetry with respect to firm performance between managers and bondholders.

In addition, REM could have negative consequences at the level of future cash flows (Roychowdhury, 2006). In particular, the survey evidence of Graham et al. (2005) shows that managers are willing to burn real cash flows and make small or moderate sacrifices in economic value to meet earnings targets. Kim and Sohn (forthcoming) find that, after controlling for other risk factors, there is a significant negative association between REM and the level of future cash flows. The bond pricing model predicts that the bond value is positively associated with total firm market value (Merton, 1974), which is a function of discounted future cash flows (Brealey & Myers, 2003). Given the negative effect of REM on the level of future cash flows, REM can affect bond value negatively.

Recent research shows that, unlike private debt holders such as banks, bondholders rely mainly on bond pricing rather than on debt covenants to protect themselves from managerial opportunism (Bharath et al., 2008; Frankel & Litov, 2007). Thus, if bondholders perceive REM as an opportunistic behavior, they will require a higher risk premium for poorer accounting quality and for taking on additional future cash flow risk.

Nevertheless, it can be difficult for outside investors to distinguish sub-optimal from optimal business decisions. Graham et al. (2005) report that managers regard REM as a less easily detectable earnings management strategy. Consistent with this belief, Cohen et al. (2008) find that, since the passage of the Sarbanes–Oxley Act (SOX), which imposes more stringent reporting standards, firms have tended to switch their earnings management strategies from accrual manipulation to REM. Furthermore, Bhojraj, Hribar, Picconi, and McInnis (2009) report that the financial market overprices firms that just beat analyst forecasts via REM in the short run. Cohen and Zarowin (2010) and Mizik and Jacobson (2008) find that financial markets overvalue firms engaging in earnings inflation at the time of seasoned equity offerings and that this overvaluation is more closely linked to REM than accruals manipulation. Their findings indicate that the stock market misprices REM in the year of manipulation.

Similarly, if bondholders do not see through managerial opportunism in financial reporting at the time of bond issuance, they may perceive REM as a desirable activity. For example, bondholders may view unusually large sales discounts as an efficient sales promotion strategy; they may think of overproduction as a normal business activity to meet the demand of increasing future sales and therefore a signal of business

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