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Do firms manipulate earnings before accelerated share repurchases?

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ABSTRACT

This paper investigates whether firms engaging in accelerated share repurchases (ASRs) conduct downward earnings management prior to repurchase announcements. The 'commitment' and high 'speed' of share repurchases in ASRs appear to give ASR firms stronger incentive to deflate the pre-repurchase earnings than open market repurchase (OMR) firms, in order to reduce repurchase costs. However, in contrast to the OMRs of Gong, Louis, and Sun (2008), we do not find such earnings management for ASR firms. We conjecture that the Sarbanes–Oxley Act and greater public attention to financial reporting after financial scandals reduce the likelihood that ASR firms adopt accrual-based earnings management.

1. Introduction

This study explores a new and rapidly growing method of repurchasing shares: accelerated share repurchase (ASR).[1] An ASR is an innovation in which a firm buys back shares by entering into a forward contract with an investment bank. According to the Emerging Issues Task Force (EITF) Issue 99-7, an ASR program is a combination of treasury stock acquisition and forward contract. A treasury stock acquisition occurs when a firm buys back its own shares from the investment bank. The forward contract in an ASR obligates the firm to repurchase a specified number of shares from the investment bank over the contract period. A typical ASR transaction is shown in Fig. 1.

Similar to open market repurchases (OMRs), ASRs are corporate events and are used by firms to buy back outstanding shares. Sloan (1996) and Xie (2001) find that there is a negative relation between pre-event earnings manipulation and post-event abnormal return.[2] Similarly, using data from OMRs, Gong et al. (2008) find that firms' long run post-repurchase abnormal returns are driven by the pre-repurchase downward earnings management. Note that ASRs are also corporate events. Similar to OMRs, Bargeron, Kulchania,

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[1] From 2004 to 2008, there were 252 ASR announcements in the U.S., for aggregate ASR proceeds of $177 billion in 2008. Compared with open market repurchases (OMRs), ASRs tend to be larger repurchase programs and to be undertaken by larger firms such as IBM or Microsoft. In addition, ASRs have become more popular: the number of ASRs in 2007 is roughly five times the number in 2004.

[2] In contrast to our supposition of downward earnings management, Teoh et al. (1998) and Shivakumar (2000) explore upward earnings management before initial public offerings and seasoned public offerings, respectively.

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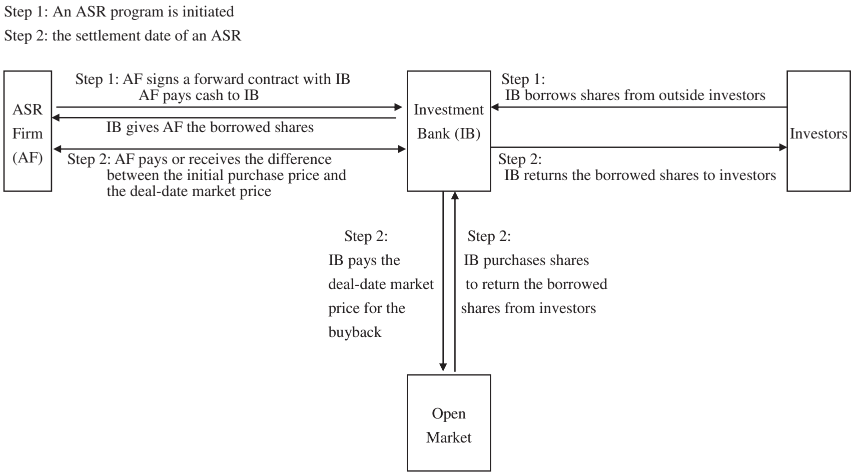

Fig. 1. Structure of an ASR transaction.

and Thomas (2011) and Chemmanur, Cheng, and Zhang (2010) find that firms with ASRs earn positive long run post-repurchase abnormal returns.[3] Thus, we conjecture that these positive abnormal returns after ASRs may be triggered by downward pre-repurchase earnings manipulation.

There are three views on the relationship between ASRs and pre-ASR downward earnings management. First, as Gong et al. (2008) suggest, the deflating pre-repurchase reported earnings are used to mislead the market to decrease the expected earnings and thereby effectively depress the repurchase cost (i.e. repurchase price). This lower repurchase cost resulting from downward earnings management can benefit managers because of the wealth transfers from the shareholders who sell shares to the remaining shareholders.[4] This argument suggests that the managers have an incentive to deflate pre-repurchase reported earnings, especially when the firm wants to actually repurchase shares, because the firm must pay for repurchases. In addition, Gong et al. (2008) find the evidence that the downward earnings management only occurs for firms that 'actually' buy back shares 'shortly' after OMR announcements.[5] Accordingly, the mechanism of ASRs that forces firms to actually buy back the pre-committed shares within one year induces managers conducting ASRs to deflate reported earnings before repurchases.[6]

Second, earnings management may be used to signal private information to the market which helps correct the valuation of the firms. Subramanyam (1996) finds that managers use accruals to improve information content. On this argument, overvalued firms may have incentive to conduct downward earnings management. Previous studies argue that firms with ASRs are more likely to be undervalued. Given that it is not possible to convey the messages of undervaluation and overvaluation at the same time, there may be no relation between ASRs and downward earnings management. Third, there may be no earnings management before ASRs because Sarbanes–Oxley Act (SOX) restricts the earnings management activity after 2004, and ASRs are implemented after 2004. In sum, the second and third views are generally alternative hypotheses to the first one, which proposes that there is a relation.

For the first view, we further consider that whether the market is misled by the downward earnings manipulation depends on whether investors are certain about the information content of the ASR.[7] In contrast to OMRs, the commitment to an ASR should result in actual repurchase. Thus, investors face no uncertainty about repurchasing. However, the information content about the managers' incentives regarding ASRs remains uncertain for investors. Bargeron et al. (2011); Chemmanur et al. (2010) and Akyol, Shekhar, and Kim (2014) suggest that ASRs are used to convey favorable information such as the undervaluation and anti-takeover effects to the market. Managers who want to signal favorable information by ASRs are unlikely to deflate pre-repurchase earnings. Given the possible managers' incentives in making ASRs, investors are unable to determine which one is the actual incentive.[8] In addition, investors cannot directly observe managers' actions. Thus, investors cannot correctly price the equity of ASRs, causing positive post-repurchase abnormal returns.[9]

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3 Chan et al. (2004), Ikenberry et al. (1995) and Peyer and Vermaelen (2009) find that firms with OMRs have long run post-repurchase abnormal returns.

4 Managers' interests tend to be aligned with those of the remaining shareholders because managers usually hold shares and future compensation in the firm.

5 These findings are presented on the second paragraph of page 948 and shown in Table 4 in Gong et al. (2008). Further, Gong et al. (2008) do not find downward earnings management when the firms do not actually repurchase shares.

6 Firm conducting an ASR 'must' repurchase the targeted number of shares within the contract period, which is usually from 30 to 360 days while Stephens and Weisbach (1998) find that nearly 20% of OMR firms do not reach the targeted number of shares within three years of the announcement.

7 Gong et al. (2008) consider two types of uncertain information content around OMRs. One comes from the fact that managers do not commit to buying back shares after OMR announcements. Another information uncertainty is caused by unclear and unobservable managers' incentives for conducting OMRs.

8 Our argument that the uncertainty motivation influences the evaluation of stock price is consistent with Fischer and Verrecchia (2000) and Gong et al. (2008). Fischer and Verrecchia (2000) show that the investors cannot correctly price a security when the market is uncertain about the managers' incentives. Gong et al. (2008) also argue that the managerial incentives of OMRs are not always clear to investors.

9 In fact, studies of ASRs such as Bargeron et al. (2011), Akyol et al. (2014) and Chemmanur et al. (2010) show positive abnormal returns after ASRs, thus indirectly implying that investors or analysts cannot revise their expectations immediately and correctly.