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Exchange listing type and firm financial reporting behavior

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ABSTRACT

We examine the link between the choice of firms to switch exchanges and managers' financial reporting behavior, and the impact of this link on post-listing performance. Among three types of exchange listings, NASDAQ-to-AMEX firms report significantly higher pre-listing abnormal accruals than do NASDAQ-to-NYSE and AMEX-to-NYSE firms. The pre-listing abnormal accruals are negatively associated with the post-listing performance, with the association driven mainly by NASDAQ-to-AMEX firms. These results suggest that the type of listing change affects managers' reporting behavior in the sense that the switch to an exchange with stricter listing standards appears to mitigate managerial incentives to inflate reported earnings.

1. Introduction

The investor recognition hypothesis posited by Merton (1987) contends that investors do not have complete information, and as such, invest only in those securities of which they are aware. As the publicity associated with exchange listing reaches some investors who were previously unaware of the stock, managers thus may switch listings in order to reduce the shadow cost of investors not knowing about their security. This suggests that exchange listing per se is an information structure.

Expressed another way, an exchange listing has information value because of the independent evaluation and approval by a stock exchange. In particular, firms switching their listing to a market with stricter listing requirements convey information about managerial confidence in the firm's future prospects (Baker & Edelman, 1991; Grammatikos & Papaioannou, 1986b; Sanger & McConnell, 1986; Ying, Lewellen, Schlarbaum, & Lease, 1977). Consistent with this argument, Chemmanur and Fulghieri (1999, 2006) note that the stricter the listing requirements of a market are, the more information is released about the firms to outside investors. The exchange listing decision and choice is thus informative because the listing standards chosen by exchanges affect their reputation, and accordingly, outsiders can partially infer the firm quality from these standards. This view is in line with the belief of stock exchanges that stringent listing standards facilitate the reduction of information asymmetries, and thus, on average, better protect investors.

Given that switching firms across different types of listing changes face different exchange scrutiny and listing requirements which also relate to the policies of required firm disclosures, managerial incentives may differ predictably from their financial reporting behavior. The regulatory environment is one of the factors that potentially affect exchange-listing firms' reporting incentives

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differently across markets. Although firms that switch exchanges face the same basic de jure regulations as do non-switching firms under the same SEC oversight, switching firms are subject to substantially greater exchange scrutiny and market demand when transferring to a market with stricter listing standards. For example, firms switching from the AMEX or NASDAQ to the NYSE are believed to have to meet more stringent regulations and policing of firm disclosures from the stock exchange, and consequentially attract more attention from the investors. Ball and Shivakumar (2005, 2008) thus argue that strict listing requirements could curb managerial incentives to engage in value destroying activities (such as earnings management) since stricter listing standards facilitate an increase in market attention and monitoring of managerial actions. As such, higher listing requirements are expected to mitigate managerial incentives to manipulate financial reporting.

However, Macey and O'Hara (2002) argue that listing requirements no longer serve their original purpose because the need for the exchange certifying role has diminished. Macey and O'Hara offer two reasons for the reduced need for exchange certification: other effective information intermediaries (e.g., investment banks, law firms, accounting firms, rating agencies, and the SEC) that provide signals about the quality of firms, and technology, particularly the use of the Internet, which has lowered the cost of research on traded companies. Nevertheless, whether the need for such a signal exists or not, the listing standards do still signal a minimum quality standard for the exchange, and as such signal the quality of the listed companies able to at least meet this minimum standard. Therefore, assessing whether strict listing requirements still work as an effective mechanism that facilitates the provision of higher-quality financial reporting by management and in turn an improved long-run performance for firms that switch stock exchanges is of interest.

Exchange listings provide a unique research design as firms undergo a transition when they switch between two markets and the listing requirements and policing of firm disclosures adopted by stock exchanges differ from market to market. As a consequence, studying these firms offers insight into the effect the demanding listing requirements and the associated market demand have on firm financial reporting. Particularly, the correlated omitted variable problem noted in Ball and Shivakumar (2005) is somewhat mitigated in the research design adopted in this study as our unit of investigation is the same firm in the same industry undergoing a transition in trading markets. Thus, our sample of exchange listings facilitates comparing of pre-listing and post-listing managerial reporting behavior in firms that switch stock exchanges, further mitigating the omitted variable problem. Through this, we are able to test the hypothesis that, as their exchange listing approaches and they encounter different exchange scrutiny and market demands, firms moving to an exchange with comparably more stringent listing standards increase the quality of their financial reporting, and vice versa.

While a substantial body of literature is available on firm performance and market reaction around exchange listings,[1] and on the association of financial reporting quality with stock returns in general,[2] little evidence exists on the information effect of prior managerial reporting behavior on post-listing performance across different types of listing change programs. Therefore, our secondary motivation for studying firm financial reporting behavior around exchange listings is to test whether post-listing performance is influenced by the exchange listing choice and financial reporting quality around exchange listings. We argue that, in general, higher financial reporting quality (i.e., mitigated earnings management) increases transparency and reduces information asymmetries, which in turn helps investors detect any temporary overvaluation at the exchange listing announcement, reducing post-listing underperformance. Based on this reasoning, we further hypothesize that the lower financial reporting quality around exchange listings for firms switching to an exchange with less stringent listing standards is associated with poorer post-listing performance.

By focusing on managerial reporting incentives around exchange listings, our investigations enable the confirmation of whether the differences in financial reporting behavior of firms across different listing change types relate to the strictness of listing requirements adopted by different exchanges, and whether there is information in firm financial reporting behavior for future performance. In this way, this paper provides a more complete understanding of the information effect that can be gained from exchange listing studies and contributes to the current debate on the functional role of listing requirements set by stock exchanges.

As prior evidence suggests that listing switches from one market place to another are also motivated by the potential for lower liquidity and trading costs (Christie & Huang, 1994; Kadlec & McConnell, 1994), exchange listing, in this sense, generates more positive information environment for the firm as well. These potential benefits may, however, tempt managers to time the listing switch and behave opportunistically. Thus, they may apply for listing when the firm is doing unusually well and the managers are uncertain or have negative private information about the firm's future prospects. If they wait the firm may deteriorate and lose the window of opportunity during which it satisfies the stricter listing criteria of the new marketplace. As a result, this paper also introduces the additional thesis that managers might deliberately engineer this rosy public image of the switching firm by manipulating financial reporting. This is sort of “hard” opportunism.[3]

To enhance comparability with prior studies, we use the measure of discretionary accruals as the proxy for managerial financial reporting behavior. Within the context of listing changes, the mitigated incentive to manipulate financial reporting associated with stricter listing requirements means that managers exert less latitude/discretion on accruals and thus report lower discretionary

[1] Prior empirical studies on exchange listings document poor long-run post-listing stock and operating performance but significantly positive abnormal returns around the exchange listing announcement. See, for example, Van Horne (1970), Ying et al. (1977), Grammatikos and Papaioannou (1986a, b), Sanger and McConnell (1986), McConnell and Sanger (1987), Baker and Edelman (1991), Edelman and Baker (1994), Dharan and Ikenberry (1995), Webb (1999), Papaioannou, Travlos, and Viswanathan (2003), and Jain and Kim (2006).

[2] For example, Leuz and Verrecchia (2000), Healy and Palepu (2001), Verrecchia (2001), Arya and Mittendorf (2005), Chan, Chan, Jegadeesh, and Lakonishok (2006), and Bergman and Roychowdhury (2008).

[3] We thank the referee for providing this argument that helps to position this paper.