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Firm size, timing, and earnings management of seasoned equity offerings

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ABSTRACT

Rangan (1998), and Teoh, Wong, and Rao (1998) maintain that the short-term overperformance and long-term underperformance of seasoned equity offerings (SEOs) are due to earnings management, whereas Loughran and Ritter (1997), Baker and Wurgler (2002) and Cohen, Papadaki, and Siougle (2007) attribute them to the timing of share placement by issuing firms. The present authors propose that large and small firms treat their seasoned equity differently: small firms time the market, whereas large firms use discretionary accruals to increase their proceeds. We verify this hypothesis using a sample of 463 firms listed on the Taiwan stock exchange. Specifically, for small firms, the timing effect is positively correlated with the firm's short-term wealth and negatively correlated with its long-term wealth. For large firms, earnings management (proxied as discretionary accruals gauged by the modified Jone's model) is positively correlated with short-term wealth and negatively correlated with long-term wealth. The separating equilibrium is unlikely to be conditioned by the issuing firm's flotation methods.

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1. Introduction

Much academic attention has been attracted to the well-documented short-term overperformance (e.g., Asquith & Mullins, 1986; Korajczyk, Lucas, & McDonald, 1990) and long-term underperformance (e.g., Kang, Kim, & Stulz, 1999; Levis, 1995; Loughran & Ritter, 1995, 1997; Mohan & Chen, 2001; Spiess & Affleck-Graves, 1995) of initial public offerings and seasoned equity offerings (SEOs). Brous, Datar, and Kini (2001) and Denis and Sarin (2001) hypothesize that the long-term underperformance arises from and therefore is employed to undo investors' overly optimistic expectations of the future performance of the issuing firms. Why would investors have these overly optimistic expectations? Numerous studies based on information asymmetry theory or agency theory suggest that the expectations are attributable to (a) the issuing firm's flotation methods (e.g., Eckbo & Masulis, 1992; Slovin, Sushka, & Lai, 2000; Wang, Chen, & Huang, 2008), (b) their timing of share issuance, and (c) their degree of earnings management. In this study, we focus on (b) and (c), which have been relatively unexplored in the literature.

By "timing," we refer to when shares are offered to the public in the market. It has been established that this generally occurs when the market is "hot" or investor sentiment is strongly positive (e.g., Asquith & Mullins, 1986; Baker & Wurgler, 2002; Loughran & Ritter, 1995, 1997; Masulis & Korwar, 1986). For example, Cohen et al. (2007) find that firms that place SEOs (hereafter SEO firms) purposely do so when the market is hot, which explains their long-term underperformance. Overly optimistic investor sentiment can also result in short-term overvaluation of seasoned shares. For example, Brown and Cliff (2004) find that prices are high when short-term investor sentiment is strongly positive. In other words, the stronger the positive sentiment, the lower the long-term performance of the SEO firm is (Baker & Wurgler, 2006; Deng, Hrnjic, & Ong, 2012). This timing argument has become one of the most prominent theoretical explanations for the anomaly associated with SEOs.

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On the other hand, according to the earnings management hypothesis, issuing firms have an incentive to manage earnings upwardly if the market fails to understand that the boosted earnings are only transitory. In the following periods, when the earnings become losses, the market revises the valuation of the shares downward. This hypothesis, which is widely supported by prior studies (e.g. Rangan, 1998; Teoh et al., 1998), predicts that issuers make unusually high pre-issue, income-increasing accounting adjustments, as a result of which post-issue earnings and stock return performance are unusually poor. Nonetheless, whether earnings management actually raises share prices is unclear. Shivakumar (2000) argues that investors are rational enough to reduce the inflated values. Therefore, firms do not use earnings management to mislead investors but rather to undo their discounting of the shares.

Shivakumar's (2000) argument is based on the premise that investors do not discount the inflated numbers equally, because the issuers cannot credibly signal the absence of earnings management. However, this premise fails to explain why some firms engage in earnings management more than others when placing their seasoned shares. Do issuing firms discount their shares differently depending on how informative they find the firm's reported numbers, that is, how helpful the issuing firms find the numbers for predicting the firm's future prospects? We therefore hypothesize that differences in the degree of earnings management depend on differences in the investor's discounting or the information value of the reported earnings.

As the SEO anomaly remains an open issue, we include firm size in our model. By doing so, we hope to contrast the mechanisms used by different firms. The extensively-studied firm-size effect is found to be negatively correlated with returns for both nonfinancial firms (Fama & French, 1992, 2008; Lin & Wu, 2013; Pontiff & Woodgate, 2008) and financial firms (Barber & Lyon, 1997) in different countries (e.g., Chan, Hamao, & Lakonishok, 1991) and in different time periods (Davis, 1994). We relate firm size to the SEO anomaly because small issuing firms are found to have much more negative long-term performance than their larger counterparts (e.g., Brav, Geczy, & Gompers, 2000; Farinós, García, & Ibáñez, 2007; Loughran & Ritter, 1997). This finding inspires us to investigate whether the firm-size effect for SEO firms is attributable to large and small issuing firms placing their seasoned equity differently.

Using firm size as a predictor, our empirical results from 463 firms listed in the Taiwan stock market indicate that large issuing firms tended to use earnings management, whereas small issuing firms tended to time the market in placing their seasoned equity shares. For large firms, discretionary accruals, which serve as the proxy for earnings management, are positively correlated with the short-term announcement effect and negatively correlated with the ex-post wealth effect. For small firms, the timing dummy is positively correlated with the short-term announcement effect and negatively correlated with the ex-post wealth effect. These results imply a separating equilibrium for the different approaches adopted by the different firms. A further question is why this is the case and not the reverse. We find that the reported earnings predict the ex-post wealth effect for large firms but not for small firms. This result provides a plausible explanation for why large firms engage in earnings management more than small firms.

In addition to market timing and earnings management, the flotation method an issuing firm uses is commonly referred to as having an impact on the SEO anomaly. A question might arise about whether the separating equilibrium found in the present study is in fact conditioned by the flotation method a firm chooses.¹ For example, the timing argument is not applicable to cases in which the existing shareholders do not renounce their pre-emption rights. Under such circumstances, the issuing firm has no incentive to time the market if the existing shareholders subscribe for the new shares in proportion to their ownership stake at the time of issuance. This possibility, if true, would jeopardize our interpretation of the findings that large issuing firms employ earnings management and small issuing firms employ market timing.

However, we argue that our finding is less likely to be preconditioned by the flotation method adopted by issuing firms. Firstly, from the perspective of information asymmetry, the adoption of a rights offer implies that the existing shareholders are willing to subscribe for the new issued shares on a *pro rata* basis; this sends a positive signal to outside investors that the proceeds collected from the issuance are being channeled to profitable investments (e.g., Eckbo, 1995; Eckbo & Masulis, 1992). Agency theory focuses on whether the flotation method could additionally involve large-block shareholders, as this would improve the management of the issuing firm (Demsetz, 1986; Pound, 1988; Shleifer & Vishny, 1986). Such improvement implies that the announcement effect, when it involves block investors, is positive. However, block shareholders are less likely to invest if the offer involves rights than if it involves bookbuilding (e.g., Aggarwal, Prabhala, & Puri, 2002; Hanley & Wilhelm, 1995; Wang et al., 2008), private placement (e.g., Wruck, 1989; Wu, 2004), or public placement (e.g., Slovin et al., 2000).

Secondly, the two flotation methods adopted in Taiwan are fixed-price offers and bookbuilding offers. However, these are not directly relevant to the aforementioned cases. With a fixed-price offer, the existing shareholders retain their pre-emption rights. (In this respect, it is similar to a rights offer). With a bookbuilding offer, the shareholders renounce their pre-emption rights. (In this respect, it is similar to public placing). However, the law in Taiwan stipulates that at least 10% of new shares must be placed with outside investors. That is, outside investors are involved whichever flotation method is used. Moreover, our statistics show that the proportion of small issuing firms that choose the bookbuilding approach (13%) does not differ significantly from the proportion of large issuing firms that choose it (14%). This result implies that choice of flotation method is not predicted by firm size. Therefore, based on both theoretical inference and the kinds of flotation methods adopted in Taiwan, we postulate that our results are less likely to be dictated by the specific flotation method chosen by an issuing firm.

Using three valuation models, Jindra (2000) finds that overvaluation is commonly found in SEOs. Insiders who know that seasoned shares are overvalued tend to engage in arbitrage. Moreover, Jindra (2000) finds earnings management to be positively

¹ Using data from Hong Kong SEOs, Ching, Firth, and Rui (2006) find that the average announcement effect is positive for private placements and negative for rights offers. Firms that adopt either method suffer inferior long-term performance.

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