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Do firms that wish to be acquired manage their earnings? Evidence from major European countries

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ABSTRACT

In this paper, we examine whether findings on downward accrual-based earnings management for firms publicly 'seeking a buyer' from the US can be extrapolated outside of the US context, given that past research has indicated that the function of the Merger and Acquisition (M&A) markets is highly dependent on the degree of competition in a country. We test for the existence of earnings management (EM) around such events for firms listed in the largest European stock exchanges between 2000 and 2009, and get evidence that downward earnings management around 'seeking buyer' announcements more strongly holds for the country with the most competitive market for corporate control in our sample, that is the UK. We consider this finding indicative of the fact that a competitive M&A environment may induce earnings management-prone behavior. We further testify significantly positive abnormal returns around 'seeking buyer' announcements for firms from the UK, but limited such evidence for the other countries, a finding we also attribute to differences in competition and uneven split of benefits among bidders and targets in M&A markets. Finally, we find that EM positively affects abnormal returns around 'seeking buyer' announcements, indicating that market participants tend to compensate for upward EM, regardless of the degree of competition of the M&A market of a country.

1. Introduction

Past research has identified upward accrual-based earnings management before Mergers and Acquisitions (M&A) from the side of acquiring firms (Erickson & Wang, 1999; Louis, 2004), however, evidence on earnings management (hereafter EM) for target firms around M&A transactions has been quite context-specific. This fact is understandable upon considering that M&A targets are not normally the deal initiators, and thus may lack both the time and the opportunity to engage in any kind of EM, which would facilitate a prospective contractual outcome (Erickson & Wang, 1999).

For a prospective target firm that wants to engage in a future M&A deal, a typical tactic would be to hire the services of an investment banking firm (Boone & Mulherin, 2007) to secure a potential buyer and receive relevant consulting services. What is less typical, and in a sense a very unusual M&A-related event, is for a prospective target firm to openly and publicly seek a buyer on its own initiative, by issuing a relevant announcement.

Murdoch and Madura (2011) have recently examined the market-value consequences of publicly issuing a "seeking-a-buyer" announcement, by identifying possibly positive (e.g. no need to rely on intermediaries) and negative (target might sound 'desperate') consequences of such a tactic. Openly seeking a buyer (hereafter SB) can be considered an ideal context for examining firm motivations to engage in accrual-based EM, given that target firms employing this unusual tactic have both the time and the opportunity to engage in such actions to affect a potential contractual outcome in their benefit: they may have the incentive to 'window dress' (Anilowski, Macias, & Sanchez, 2009) to attract a buyer, and therefore engage in upward EM, or, alternatively, downward EM could also represent a possibility in order to constitute a more price-attractive target. Recent US evidence (Anagnostopoulou & Tsekrekos, 2012) has indicated that SB firms on average engage in significant downward EM around the issuance of a SB announcement, pointing towards the second possibility.

In this paper, we examine whether findings on downward EM for firms issuing a SB announcement are robust outside the US. This is because the function of the markets for corporate control is expected to be highly dependent on the degree of competition and shareholder protection in a particular country (Alexandridis, Petmezas, & Travlos, 2010). Potential bidders could more easily end up in overpaying in countries with highly competitive M&A markets e.g. the US or the UK, while in the less competitive markets (e.g. rest of Western Europe), the benefits of relevant transactions are more evenly split between targets and acquirers (Alexandridis et al., 2010). In this context, we expect that SB firms in more competitive environments may be more prone to engage in EM to facilitate a possible deal, resulting exactly from this high degree of competition, in comparison to firms from countries where competition in M&A markets is less intense. At the same time, the level of EM is expected to significantly differ across countries,

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depending on the degree of investor protection and the quality of local enforcement mechanisms (Leuz, Nanda, & Wysocki, 2003), making firms more or less prone to engage in EM in some countries in comparison to others (and regardless of the degree of competition in the M&A market of a given country).

We test for the existence of earnings management around 'seeking buyer' announcements issued by firms from major European countries during 2000–2009. We focus on the UK, France, Germany, and Italy, all of which posses a satisfactory number of SB announcement firms, which makes relevant examination meaningful and intuitive. We limit our analysis to IFRS reporting firms (despite a sharp reduction in the number of observations before 2005 i.e. the year of mandatory adoption) to secure a uniform reporting environment, and we document that findings on downward EM previously observed for the US are also confirmed for the UK and Italy, but not for other countries. Our results are robust to alternative ways of measuring accrual-based earnings management, as well as to the impact of performance on the estimation of accruals. We interpret the similarity of our UK findings to previous US findings as indicative of the fact that the M&A market characteristics of the two countries are at the root of similar firm behavior around SB announcements. We further consider that the absence of significant findings for other European countries indicates that a less competitive environment in these countries does not serve as a trigger for relevant EM-prone behavior. The only country other than the UK for which evidence on EM is found is Italy, which is also a country scoring generally very highly on the EM index of Leuz et al. (2003). This last observation could imply a higher tendency for EM in an effort to guide contractual outcomes for this country in particular, despite the fact that it belongs to the pool of countries with less competitive M&A markets.

Moreover, there is ample evidence that M&A target firms realize positive abnormal stock returns around the deal announcement (indicatively Alexandridis et al., 2010; Croci, Petmezas, & Travlos, 2012; Martynova & Renneboog, 2011 among others), while acquiring firms realize zero or even negative abnormal returns (Andrade, Mitchell, & Stafford, 2001; Travlos, 1987). However, the degree of competition in a country's market for corporate control has been considered a significant factor for the existence of abnormal stock returns for bidders vs. targets around M&A deal transactions (Alexandridis et al., 2010), with abnormal returns for acquiring firms to be more strongly negative, and target returns to be positive in more competitive countries, while target shareholders are found to gain significantly less, and bidders to often realize gains instead of losses in less competitive markets (see Alexandridis et al., 2010). In this context, the second scope of this paper is to test for the existence of abnormal stock returns around SB announcements for our sample countries outside of the US context, and also examine the impact of EM on market performance around SB announcements. In case targets gain more around M&A deal announcements in more rather than in less competitive countries, we expect that SB firm gains will be higher (lower) in more (less) competitive environments. This is because market participants may be anticipating that the future benefits of a potential deal may be relatively stronger (weaker) for a target firm in a more (less) completive environment.

In accordance with our theoretical expectations, we find significantly positive abnormal returns around SB announcements by UK firms, but limited such evidence for SB firms from the rest of the European countries in our sample. This way, as target firms have been found by past research to gain significantly less in countries with less, as opposed to more M&A market competition, the same pattern is observed for firms wanting to become potential M&A target firms. Finally, in accordance with previous evidence for the US, we find that EM positively affects abnormal returns around SB announcements for our pooled sample of European firms. This result, although cannot be confirmed on a country by country basis due to the small size of our sample, is in accordance with past evidence for the US (Anagnostopoulou & Tsekrekos, 2012), indicating that market participants tend to compensate for upward EM regardless of the degree of competition of the M&A market in a particular country.

Overall, our findings indicate that the degree of competition in a market may be a significant contributor for market performance and earnings management by potential M&A targets, well and above actual targets of M&A transactions, assessed after a transaction has taken place. We therefore conclude that the extrapolation of any form of expected firm behavior and market reaction around M&A events based on single country evidence cannot be performed across jurisdictions before accounting for differences in competition and institutional factors.

The rest of the study is organized as follows: In Section 2, we summarize the main findings of past research papers that are related to our study. Section 3 presents the theoretical discussion and offers the motivation for this study. Section 4 presents the sample selection process and outlines the methodology with respect to the measurement of earnings management and the calculation of returns. Section 5 reports a brief sample description and empirical findings, and finally the study concludes with Section 6, which summarizes the research findings.

2. Related research

Despite the fact that past research has strongly indicated the existence of upward earnings management (EM) for acquiring firms in the context of M&A deals, evidence on EM for the targets of such deals has not been so clearly directional. One steam of research has provided evidence on positive, but not always significant EM for target firms (Erickson & Wang, 1999), and upward EM in the case of hostile, as opposed to friendly takeovers (Easterwood, 1998), in order to impede a possible deal. At the same time, there exists other evidence on downward EM for targets of friendly acquisitions (Ben-Amar & Missonier-Piera, 2008; Eddey & Taylor, 1999), in an effort to facilitate the conclusion of the transaction and boost financial results in the post-merger period (Ben-Amar & Missonier-Piera, 2008).

The fact that evidence on targets has been quite context-dependent is understandable if one takes into account the fact that these firms are not normally the deal initiators, and thus may lack the opportunity, or time, as Erickson and Wang (1999) point out, to engage in any kind of EM which would best serve their interests in a prospective deal.[1]

An M&A-related event that can be characterized (at the very least) as unusual in nature, is for a firm to openly and publicly seek a buyer on its own initiative, by issuing a relevant announcement. The market-value consequences of publicly issuing a 'seeking a buyer' announcement (hereafter SB) have been recently studied by Murdoch and Madura (2011), who identify both positive and negative consequences of such an announcement: on the positive side, there is no need to rely on intermediaries, and the bidder may face less resistance, making the deal more attractive, but on the other hand, the target might sound 'desperate' or have previously failed to find a buyer through private negotiations, or potential bidders might be deterred by the fact that the bid may end up being too competitive (Murdoch & Madura, 2011). They identify a number of motives behind SB announcement, including strategic reasons, leverage, growth, or distress, but their findings indicate that overall the practice of publicly 'seeking a buyer' does not improve a firm's chances for attaining its goal. However, they do find evidence on significant abnormal returns around SB announcements, indicating that market participants consider the action to be in the best interest of the firm.

3. Theoretical discussion and motivation

With respect to accrual-based EM in the context of firms openly SB, this setting could represent a probably ideal context for such

[1] Lo (2008) underlines that the practice of EM requires the existence of both motive and opportunity, as would be the case with a crime.