Earnings Management, Corporate Governance and the Market Performance of Seasoned Equity Offerings in Hong Kong

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Abstract

This paper examines the use of discretionary current accruals by firms that make seasoned equity offers (SEOs). We find evidence suggesting that firms borrow future income to manage earnings in pre-issue years and consequently earnings decrease in post-issue year 2. However, we find no evidence that pre-issue discretionary accruals affect future stock returns. We find evidence that family-owned firms are more likely to use positive discretionary accruals prior to making an SEO, independent directors and outside blockholders constrain earnings management in family-controlled firms and SEO firms that have a larger board size have a higher degree of earnings management around SEOs.

JEL Classifications: G32, G34

Keywords: earnings management, corporate governance, seasoned equity offering

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1. Introduction

Seasoned equity offerings (SEOs) provide a direct incentive to manage earnings. To the extent managers can undetectably increase reported earnings, they can improve the terms on which their firms' shares are sold to a third party. In support of this, Rangan (1998), Teoh et al. (1998) and Marquardt and Wiedman (2004) have shown that managers manipulate earnings in periods around SEOs. Their studies argue that managers overstate earnings before SEOs because of opportunism. Marquardt and Wiedman (2004) further argue that earnings of SEO firms are managed upward by accelerating the recognition of revenue. Shivakumar (2000) also reports earnings management by firms making SEOs, but he argues that investors are able to identify these discretionary accruals and price the stock according to its fundamentals. He argues that earnings management at the time of an SEO is a rational behavior by the managers as the stock market expects them to engage in this practice.[1] Most research studies on earnings management and all the studies cited above, use data from the US. In comparison, there is a dearth of research in other countries.

To investigate whether earnings management takes place around SEO announcements is important from the viewpoint of investors, analysts and regulators. Teoh et al. (1998) and Rangan (1998) argue that poor post-issue performance[2] can be explained, in part, by the pre-issue earnings management of seasoned new issuers.[3] This implies investors could use the information contained in the pre-offering accounting accruals to discriminate among seasoned equity issuers[4] and invest in those firms with negative or low discretionary current accruals. Of course, some skill is needed to detect and unravel the earnings management. Regulators should pay attention to accounting practices that misrepresent or otherwise induce false pictures about firms' performances at the time of SEOs. If investors cannot 'see through' the accounting practices, they will be induced to buy the stocks of those firms with higher but 'false' reported earnings at the time of SEOs and so scarce capital resources will be misallocated. Regulators have a responsibility to identify situations where earnings management has a greater likelihood of occurrence and to take corrective actions.

In this study we use data from Hong Kong to explore whether abnormal or discretionary accruals are used to boost reported earnings before the issue of SEOs and whether any identified earnings management is associated with future stock returns. It is important that national studies be undertaken because the prevalence and extent of earnings management are likely to be functions of the specific environment that the firm operates in. For example, corporate governance mechanisms as well as monitoring and oversight activities will affect the use of earnings management and the importance of these factors differs across firms

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[1] Shivakumar (2000) calls this argument the managerial response hypothesis. This hypothesis contrasts with the overvaluation hypothesis that says managers have incentives to issue new equity when the firm is overvalued.

[2] Empirical studies in the US have documented poor post-issue earnings performance (Hansen and Crutchley, 1990; McLaughlin et al., 1996) and poor post-issue stock returns (Loughran and Ritter, 1995; Spiess and Affleck-Graves, 1995). Brous (1992) and Jain (1992) find that security analysts significantly lower their forecasts of the short-term earnings of issuing firms in response to SEO announcements.

[3] Note, however, that Shivakumar (2000) finds no association between abnormal accruals and long-run stock returns.

[4] Discretionary accruals in the period surrounding the offering predict a portion of the subsequent poor earnings and stock price performance.

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