Journal of Corporate Finance 25 (2014) 1–15

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Stock repurchases as an earnings management mechanism: The impact of financing constraints

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ARTICLE INFO

Article history:
Received 18 November 2011
Received in revised form 22 October 2013
Accepted 24 October 2013
Available online 31 October 2013

JEL classification:
G30
M41

Keywords:
Share repurchase
Financing constraints
Earnings management

ABSTRACT

Our paper provides evidence regarding the use of share repurchases as an earnings management mechanism in the presence of debt-financing constraints as well as the impact of these constraints on the use of accruals and other real earnings management techniques. We document that share repurchases are prevalent as a mechanism to increase earnings per share. Next, we show that the presence of debt-financing constraints discourages the use of repurchase-based earnings management. We also find that for firms more likely to be engaged in earnings management, high financing constraints appear to increase the use of accruals based earnings management and decrease the use of other real earnings management techniques.

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1. Introduction

Healy and Wahlen (1999) define the occurrence of earnings management as when "managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers" (p. 368).

Motivation to manage earnings can be opportunistic or principled. Previous empirical studies show that managers are motivated to opportunistically manage earnings in order to meet analyst expectations (Gunny, 2010; Skinner and Sloan, 2002), avoid losses (Burgstahler and Dichev, 1997), maximize managerial compensation (Cheng and Warfield, 2005; Healy, 1985), evade debt covenant violations (DeFond and Jiambalvo, 1994) and maximize stock price prior to security issuance (Teoh et al., 1998a,b). However, a growing stream of empirical literature also shows that earnings management is used to signal private information to the market. Louis and Robinson (2005) find evidence consistent with managers using discretionary accruals to signal favorable private information in conjunction with stock splits. Linck et al. (forthcoming) analyze how firms utilize discretionary accruals to credibly signal positive investment opportunities to the market in an effort to reduce financing constraints.

A substantial body of research also analyzes earnings management techniques utilized by managers ranging from accruals management to real earnings management techniques such as sales discounts, relaxed credit policy, overproduction and R&D reduction.[1] Share repurchases have also begun to attract researchers' attention as a mechanism to manage earnings. Hribar et al.

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[1] Examples of research focusing on accruals management include Burgstahler and Dichev (1997), DeFond and Park (1997), and Dechow et al. (2003). Examples of research focusing on real earnings management include Roychowdhury (2006) and Gunny (2010). Examples of research focusing on both types of earnings management include Cohen et al. (2008) and Zang (2012).

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http://dx.doi.org/10.1016/j.jcorpfin.2013.10.004

(2006), Bens et al. (2003) and Myers et al. (2007) find evidence suggesting firms use share repurchases to increase earnings per share (EPS) in order to avoid missing analysts' EPS estimates, to meet certain EPS growth targets, or to avoid an EPS decrease, respectively. When firms repurchase shares that increase EPS by at least one cent relative to the EPS without the repurchase, such repurchases are called accretive repurchases.

We examine how financing constraints affect the use of accretive repurchases. Existing papers on accretive repurchases focus on the average firm and do not examine the cross-sectional variation in the use of accretive repurchases. We expect financing constraints to influence accretive repurchases because like other real earnings management techniques, accretive repurchases also have a real cash flow effect. That is, accretive repurchases drain the firm's cash. We argue that firms must have either sufficient cash flow or financial slack (i.e. financially less constrained) to finance repurchases as we would not expect individual firms to engage in share repurchases financed by equity issues just to increase earnings per share.

We focus on financing constraints because numerous papers have shown that financing constraints are a major friction that impacts corporate policy such as investment and capital structure (Froot et al., 1993). The novelty in this paper is we expect the same constraints to impact a firm's behavior with regards to earnings management through share repurchase activity.

We begin our investigation by documenting the prevalence of accretive repurchases during the past two decades. We find that the proportion of firms engaging in accretive share repurchases has increased from 9% in 1983 to almost 21% in 2011 (see Fig. 1a). When analyzing the subset of firms that repurchase stock, we find that half (50.3%) of repurchasing firms in 2011 engaged in accretive share repurchases compared to about 39% in 1983 (see Fig. 1b). Over the entire twenty year time period, accretive share repurchase activity constituted, on average, over 43% of the repurchase activity. These findings suggest that accretive repurchases are a major earnings management technique.

To analyze whether financing constraints influences the use of accretive share repurchases, we draw on Hadlock and Pierce (2010). We begin by examining the occurrence of accretive repurchases across ten firm deciles ranked by an HP Index that measures financing constraints (a higher index indicates greater financing constraints). We find a monotonic relation across deciles indicating that as financing constraints decrease (lower HP index), accretive repurchases occur more frequently. Next, we estimate logit models and confirm that lower debt-financing constraints encourage the use of accretive repurchases. More specifically, we document that large and mature firms are more likely to engage in accretive share repurchases. We also analyze whether intertemporal variation in financing constraints can explain intertemporal changes in aggregate accretive repurchases using the Fama and French (2001) approach. Conditional on financing constraint proxies, we estimate the expected proportion of firms engaging in accretive repurchases. We find that expected proportions reasonably forecast the actual proportions, implying that debt-financing constraints have an economically meaningful influence on the use of accretive repurchases. Thus, we show that the presence of debt-financing constraints discourages the use of repurchase-based earnings management.

We extend the analysis to determine how financing constraints impact the use of accruals and other real earnings management techniques. Once managers decide to manage earnings, they may use share repurchases, other real earnings management and accruals. We argue that the choice between the alternatives will be dependent upon firm characteristics and financial constraints. We identify a sub-sample of firms that are more likely to be suspected of managing earnings. Specifically, we identify a sample of firms that either just meet or beat a zero earnings benchmark, last year's EPS, or the mean analyst EPS forecast. We begin by estimating normal levels of accruals and real earnings management activities through overproduction and reduction in R&D, advertising and SG&A. Next, we perform a Heckman two-stage regression utilizing characteristics of firms suspected of managing earnings in the first stage equation. In the second stage equations, we document a negative (positive) relation between financing constraints and the use of repurchased based (accruals) and other real earnings management while controlling for firm characteristics shown to influence various earnings management techniques.

As noted by Healey and Whalen (1999), to continue to inform the debate about the implications of earnings management for standard setters, an additional understanding of what factors limit earnings management is important. Our paper is the first to provide evidence of a direct link between the earnings management and financing constraints literature. Previous research documents that financing constraints influence firm behavior and firm value. Denis and Sibilkov (2010) find that greater cash holdings of financially constrained firms are value enhancing due to the increased cost of external financing. Li (2011) finds a strong interaction effect between financing constraints and R&D investment on expected returns. Specifically, he finds that the positive R&D and return relation only exists among highly financially constrained firms. Edwards et al. (2013) find firms facing financial constraints exhibit lower cash effective tax rates suggesting that financial constraints impact a firm's tax avoidance strategies. Extending this literature, we find that financially constrained firms are less likely to utilize share repurchases to manage EPS. More generally, when firms manage earnings, financing constraints is a major determinant of accretive repurchases as well as other types of accruals and real earnings management techniques.

The remainder of the paper is organized as follows: Section 2 describes the sample and the associated statistics. Section 3 includes a discussion of the empirical results and Section 4 concludes.

2. Sample selection and variables

2.1. Sample selection

We draw data from various sources. Financial accounting information is from COMPUSTAT annual files. Stock market related information is from COMPUSTAT and CRSP monthly security files. Analyst earnings forecasts are from I/B/E/S summary files.

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