



Advances in Accounting, incorporating Advances in International Accounting

Contents lists available at ScienceDirect
journal homepage: www.elsevier.com/locate/adiac



Earnings management surrounding M&A: Role of economic development and investor protection☆

Mohammad A Karim Assistant Professor of Finance^{a,*},
Sayan Sarkar Assistant Professor of Accounting^b, Shaorong Zhang Associate Professor of Finance^c

^a Division of Finance and Economics, Marshall University, College of Business, Corbly Hall 259, Huntington, WV 25755, USA

^b University of Mary Washington, College of Business, Rm. 248, Fredericksburg, VA 22401, USA

^c Division of Finance and Economics, Marshall University, College of Business, Corbly Hall 215, Huntington, WV 25755, USA

ARTICLE INFO

Article history:

Received 9 September 2015

Received in revised form 30 September 2016

Accepted 1 October 2016

Available online xxxx

JEL classification:

G14

G15

G34

Keywords:

Mergers & acquisitions

Earnings management

Investor protection

ABSTRACT

We examine accruals based earnings management by acquiring firms surrounding merger and acquisition events from thirty countries for the period 2004–2015. We find that the acquiring firms do manage earnings surrounding mergers when the method of payment is acquirer's stock, but there is no such evidence when the method of payment is cash. We also examine whether level of economic development and country-specific institutional characteristics play any role in acquiring firms' earnings manipulation. Using two groups of countries based on the level of economic development and nine different institutional variables we find evidence that acquirers' accrual manipulation differs based on such characteristics.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

In their review paper, Healy and Wahlen (1999) define earnings management as the alteration of financial reports by managers when they use judgment in financial reporting or in structuring transactions to either mislead some stakeholders about the economic performance of the company or to influence the contractual outcomes that depend on reported accounting numbers. Managers can use their discretion in unexpected accruals or accounting method choices to alter financial reports.

Early studies examining earnings management surrounding capital market transactions find evidence that managers manipulate earnings through accruals to influence short-term stock price performance in the capital markets surrounding these major corporate transactions. See for example, Perry and Williams (1994) for management buyouts, Teoh, Welch, and Wong (1998a) for seasoned equity offerings, Teoh,

Welch, and Wong (1998b) for initial public offerings, and Erickson and Wang (1999) for stock-financed acquisitions.

More recently, researchers have also investigated how earnings management practice varies across countries with different legal environments, levels of investor protection and capital market developments. For example, Leuz, Nanda, and Wysocki (2003) document that earnings management is more pervasive in countries where investor protection is weak than in countries where investor protection is strong, as strong and well enforced outside investor rights limit the ability of insiders to acquire private control benefits and hence, reduce the incentive to manage earnings.

Erickson and Wang (1999) are the first to document earnings management by acquirers in stock-financed acquisitions for a sample of U.S. transactions in quarters surrounding announcement date. Louis (2004) also examines earnings management of a sample of U.S. acquirers by focusing on the earnings reversal. Botsari and Meeks (2008) document evidence of earnings management by acquirers in the United Kingdom, and Higgins (2013) in Japan. There have been many merger and acquisitions in other countries as well in the last few decades. But there has been little evidence on earnings management practice surrounding M&A events in other countries. We try to fill this void.

In this paper, we use a sample of merger and acquisitions from 30 countries from 2004 to 2015 to examine earnings management by acquirers in stock-financed acquisitions. By studying the earnings

☆ We thank Giorgio Gotti and Shofiqur Rahman for their valuable comments and support. This article was partially funded by Summer Research Grant, College of Business, Marshall University, WV. We retain responsibility for any remaining errors.

* Corresponding author.

E-mail addresses: karimm@marshall.edu (M.A. Karim), ssarkar@umw.edu (S. Sarkar), zhangs@marshall.edu (S. Zhang).

management of a large sample of acquisitions from 30 countries with diverse legal environments, levels of investor protection and capital market developments, we are able to shed light not only on the pervasiveness of earnings management practice in M&As, one of the important capital market transactions, but also on the factors that can deter managers' incentive to manage earnings aggressively.

Using both unexplained current accruals and abnormal current accruals, two commonly used measures for earnings management, and a sample of 1630 acquisitions in 30 non-US countries in the SDC Platinum Mergers and Acquisitions database from 2004 to 2015, we find that acquiring firms' earnings management depends on the method of payments, i.e. cash or acquirers' stock. When the method of payment is the acquirer's stock, we find significant increase in both unexplained current accruals and abnormal current accruals reported by the acquirers between the announcement and effective dates, evidence that on average acquirers in non-U.S. countries also manage earnings surrounding mergers. However, when the method of payment is cash, we find virtually no change in unexplained current accruals or abnormal current accruals at all in the two years surrounding the acquisition announcement date or effective date. Consistent with Erickson and Wang (1999), Louis (2004), Botsari and Meeks (2008), and Higgins (2013), our results suggest that acquirers in other countries have the same incentives to manage earnings when the method of payment is their own stock. By increasing earnings through accruals manipulation, acquirers can temporarily inflate their stock price and hence provide economic benefit to the acquiring firms' shareholders and the managers.

When we divide our sample acquirers based on economic development of the countries they reside, i.e. developed vs. developing countries, we find that the significant increase in unexplained and abnormal current accruals is mostly driven by acquiring firms from developing countries. However, there is relatively smaller change in both unexplained and abnormal current accruals in quarterly reports in the two years surrounding effective dates for acquirers from developed countries. In comparison to the findings by Erickson and Wang (1999), Louis (2004), Botsari and Meeks (2008) and Higgins (2013), we find similar but significantly smaller evidence of earnings management by acquirers from developed countries.

A country's economic development and capital market development are closely related. To better understand what factors cause the difference between earnings management by acquirers from developed and developing countries, we further examine if country-level legal and governance related institutional characteristics play any role in affecting the incentives of manipulating earnings by acquirers. Following Leuz et al. (2003), for a sub-sample of firms from 20 countries that we have these legal and governance measures, we find that only acquirers in countries with weak investor rights, less stringent disclosure requirement, and less developed financial markets manage earnings. In contrast, there is no statistically significant evidence of earnings management by acquiring firms in countries with better investor protection, more stringent disclosure requirement, and more developed financial markets.

2. Theories, motivations and hypotheses

A number of studies have examined earnings management surrounding major corporate transactions. The purpose for managers of firms involved in these transactions is to gain economic benefits by temporarily reporting higher or lower income surrounding these transactions through accounting items at the managers' discretion, such as accruals. Healy and Wahlen (1999) survey studies on earnings management in management buyouts, equity offerings, and to meet financial analysts' earnings expectations or management's own forecasts, and conclude that there is compelling evidence that managers manage earnings.

Stock-financed acquisitions could be another type of capital market transaction in which managers have strong incentives to manage earnings to gain economic benefits. In a stock-financed acquisition, an acquirer uses its own stocks (usually newly issued) to exchange for the acquired shares at certain ratio agreed by the acquirer and acquired on the deal agreement date. Thus, before the agreement date, the acquirer has the incentive to influence the short-term stock price performance in order to lower the costs to the acquirer. One way that managers can temporarily inflate their stock price is to report better earnings in the periods leading up to the agreement date if better reported earnings are able to raise stock price. But there will be no such incentive for managers of acquiring firms to manage earnings if the acquiring firms pay with cash.

Shleifer and Vishny (2003) propose a merger and acquisition model of market misvaluation suggesting that the market is inefficient and rational managers have strong incentive to have their firms' equity overvalued, and then they can use the overvalued equity of their firms to acquire undervalued firms cheaply.

Erickson and Wang (1999) study the reported earnings of acquiring firms in the quarters preceding the acquisition announcements and between the announcement and agreement dates when the acquisitions are paid with acquirers' own stock. They find evidence that acquiring firms manage earnings in the quarter prior to the deal announcement and in the quarters between the announcement and agreement dates, as the unexpected accruals in these quarters are significantly higher by 2% to 3%. They also find that the degree of earnings management is significantly positively related to the size of the deal as large deal provide stronger incentives to so do. They postulate that it is a rational response by acquiring firms to manage earnings in pre-merger periods to mitigate the post-merger price reversal as investors generally expect the acquiring firms to manage earnings and hence discount the stock prices at the acquisition announcements whether earnings are managed or not.

Consistent with Erickson and Wang (1999), Louis (2004) also uses earnings management as a possible explanation for post-merger underperformance anomaly of acquiring firms. He finds that acquiring firms manage earnings in the quarters preceding stock based acquisitions. In post-merger period, stock-based acquirers' underperformance is partly due to the pre-merger earnings management and its subsequent post-merger reversal. Similarly, D'Avolio, Gildor, and Shleifer (2001) postulate that acquiring firms in stock based acquisitions have strong incentives to raise stock prices and further find that raising stock prices through earnings manipulation by acquirers has become more prevalent in stock based acquisitions.

Researchers have also found earnings management surrounding stock based mergers in other countries. For example, Botsari and Meeks (2008) examine discretionary accrual based earnings management surrounding stock for stock mergers in United Kingdom for the period 1997–2001. They find that acquiring firms engage in income-increasing accrual manipulation prior to merger announcement. Higgins (2013) finds evidence of earnings management by acquirers in Japan. She finds that Japanese acquirers report significant positive abnormal long-term accruals in pre-merger periods.

The evidence in all the afore mentioned studies supports the idea that acquiring firms have incentives to inflate their stock prices before stock based acquisitions and managers of acquiring firms manage earnings surrounding announcements to achieve that, and earnings manipulation is a rational response of managers of acquiring firms as they anticipate the market will discount their stock prices whether they have done that or not. However, these studies mostly concentrate on acquirers from developed countries such as the United States, the UK and Japan. Although, we would expect managers of acquiring firms in other countries to act similarly, whether acquiring firms in other countries will act similarly to

Download English Version:

<https://daneshyari.com/en/article/7340002>

Download Persian Version:

<https://daneshyari.com/article/7340002>

[Daneshyari.com](https://daneshyari.com)