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Managerial reporting behavior around exchange switching: Consideration of current and future performance[☆]

Wen-Chun Lin [b], Tsai-Ling Liao [a,*]

[a] Department of Business Administration, College of Management, National Formosa University, No. 64, Wunhua Road, Huwei, Yunlin 632, Taiwan
[b] Department of Finance, National Taipei University of Business, No. 321, Sec. 1, Jinan Road, Taipei, Taiwan

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ABSTRACT

By examining firms switching trading markets from the NASDAQ or AMEX to the NYSE and from the NASDAQ to the AMEX, we find that switching firms typically report significant positive abnormal accruals in the year preceding exchange switching. The pre-switching abnormal accruals are negatively associated with post-switching stock and operating performance, with the association driven mainly by firms with poor earnings in both current and future periods. The results suggest that pre-switching earnings management behavior, on average, supports the managerial opportunism, but not the signaling, intent. In further analysis, we find some evidence that firms with good performance in both current and future periods tend to choose income-decreasing reporting to avoid competition and/or mitigate adverse political attention.

1. Introduction and overview

Market participants are likely to respond to news of exchange switching because of its perceived effect on the firm. Although there is little theoretical justification to believe exchange switching affects all firms equally, prior empirical studies have documented that the average firm experiences significantly positive excess returns prior to switching.[1] Papaioannou, Travlos, and Viswanathan (2003) also examine operating performance around the listing change and find evidence of a pattern of pre-switching improvement in operating performance. The favorable pre-switching performance is largely ascribed to the information signaling effect. A common explanation for this information-based effect is related to the motives of management for changing trading marketplace, including the desire to gain prestige and visibility (Jain & Kim, 2006; Kadlec & McConnell, 1994; Merton, 1987; Van Horne, 1970), to convey confidence in future prospects of the firm (Baker & Edelman, 1991; McConnell & Sanger, 1984; Ying, Lewellen, Schlarbaum, & Lease, 1977), and to improve stock liquidity (Christie & Huang, 1994; Kadlec & McConnell, 1994).

Given the motivations, managers of switching exchange listings are supposed to have a strong incentive to report favorable accounting information in the prospectus to influence investors' perception of the firm's value. According to Merton's (1987) investor recognition argument, the publicity associated with switching exchange listing reaches some investors who were previously unaware of the stock; managers thus may exchange-list to reduce this shadow cost of not knowing about a security. Therefore, if switching firms

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* Corresponding author.
E-mail addresses: fnwjlin@ntub.edu.tw (W.-C. Lin), tlliao@nfu.edu.tw (T.-L. Liao).

[1] See Van Horne (1970), Ying et al. (1977), Grammatikos and Papaioannou (1986), Sanger and McConnell (1986), McConnell and Sanger (1987), Baker and Edelman (1991), Edelman and Baker (1994), Dharan and Ikenberry (1995), Webb (1999), and Jain and Kim (2006), etc.

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manage earnings upward before exchange listing to attract investor attention and the market fails to perceive that the earnings management represents transitory increases in earnings, these firms will be overpriced due to investor optimism around the exchange switching announcement. Subsequently, when earnings management reverses and switching firms report declined earnings in the post-switching period, disappointed investors would revise their valuation downwardly.[2]

However, given that a listing change announcement may serve as an expression of manager confidence in the future prospects of the firm (Baker & Edelman, 1991; Ying et al., 1977), managers of switching firms might have incentives to credibly use discretionary accruals, the proxy of earnings management, to signal private information about the future prospects of the impending listing change rather than to mislead investors. Consistent with this argument, prior studies indicate that managers use their reporting discretion to signal private information through accruals.[3] For example, Louis and Robinson (2005), Louis and White (2007), and Linck, Netter, and Shu (2013) suggest that combining the accrual information with other corroborating signals may enhance accrual credibility as a means of signaling managerial optimism rather than managerial opportunism. Accounting research suggests that accrual management is not an unmitigated evil; within limits, it promotes efficient decisions.

Based on the reasoning, exploring the effect of exchange switching decisions on managers' incentives for their accrual behavior enables us to ascertain whether information on discretionary accruals provides insight into the valuation of firms changing trading marketplace. Therefore, this study examines managerial reporting behavior around exchange switching announcement and the effect of pre-switching discretionary accruals on post-switching stock and operating performance, especially focusing on the design that managers take account of current and future expected earnings. Examining the association of pre-switching accruals with long-run post-switching performance will hopefully reveal whether managerial optimism or managerial opportunism drives the accrual behavior before exchange switching. Additionally, as the discretionary accruals usually reverse in a future period, the impact of earnings management is often transient. In this sense, the anticipation of future earnings may be extremely important for managerial reporting choices in the presence of specific corporate events.

Theoretically, specific corporate events (e.g., switching exchange listing) should not affect all firms equally with respect to managerial reporting behavior of discretionary accruals. Consistent with this view, the analytical model of Fudenberg and Tirole (1995) justifies that managerial incentives for earnings management depend on their consideration of both current and future relative performance. Fudenberg and Tirole argue that managers prefer a smooth profile of earnings streams over time via career concerns, and thus have incentives to increase current earnings in bad times by borrowing against future earnings. By contrast, managers have incentives to decrease current earnings in good times and transfer them to future periods when future earnings are expected to be poor. Namely, Fudenberg and Tirole suggest that managers choose current discretionary accruals partially in anticipation of future earnings. Consequently, the implications indicate that managerial reporting incentives around exchange switching might differ for firms with various combinations of current and future relative performance.

Based on firms switching trading markets from the NASDAQ or AMEX to the NYSE and from the NASDAQ to the AMEX during 1986–2012, the empirical results show that switching firms typically overstate their earnings by reporting significantly positive discretionary accruals in the year preceding a listing change announcement, subsequently followed by poor long-run post-switching earnings and insignificant abnormal accruals. Pre-switching abnormal accruals are negatively associated with post-switching stock and operating performance. The inverse relation is robust with respect to an extensive set of controls, alternative accrual measure using cash flow data and testing methods. The results manifest the reversal of price effects of pre-switching earnings management, supporting the managerial opportunism, but not the signaling, intent.

This study further suggests that managerial consideration of both current and expected future earnings affects firm reporting behavior around exchange listing. The evidence of pre-switching upward earnings management is observed especially for firms with both poor current and future earnings and for those with poor current and good future earnings. For firms with good performance in both current and future periods and those with good current and poor future performance, the evidence shows downward earnings management prior to the exchange switching announcement. Interestingly, the findings on managerial accrual behavior reveal that the incentive to inflate (deflate) earnings prior to exchange switching increases (decreases) in anticipation of good future performance by managers. Based on subsamples with different combinations of current and future expected earnings, the regression results indicate a significantly negative relation between prior discretionary accruals and the cross-sectional variation in post-switching earnings and stock returns for firms with poor performance in both current and future periods. Because the effect of opportunistic earnings management has to reverse over time, this finding is consistent with the conjecture that managers of these firms are likely to use their reporting discretion to opportunistically manage earnings upward prior to exchange switching, providing support for the managerial opportunism intent.

Unlike opportunistic earnings management, the smoothing of earnings across time apparently should have little reversal effect. In this sense, the failure to find a significant association between pre-switching earnings management and long-run performance following the exchange switching announcement is consistent with the earnings smoothing argument. The results for switching firms with good current and poor future earnings and those with poor current and good future earnings support this point.

With respect to sample firms with good earnings in both current and future periods, no significant association is found between pre-switching earnings management and post-switching performance. The fact that the average firm with good performance in both

[2] Most studies on management reporting behavior around firm-specific events, including management buyout (DeAngelo, 1986; Perry & Williams, 1994), IPOs (Aharoney, Lin, & Loeb, 1993; Ducharme, Malatesta, & Sefci, 2001; Teoh et al., 1998a), SEOs (Rangan, 1998; Teoh et al., 1998b), and stock repurchase (Gong, Louis, & Sun, 2008), interpret the evidence of earnings management as support for managerial opportunism.

[3] See Watts and Zimmerman (1986), Subramanyam (1996), Demski (1998), and Arya, Glover, and Sunder (2003).