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Corporate diversification, real activities manipulation, and firm value

Javeria Farooqi [a], Oneil Harris [b], Thanh Ngo [b,*]

[a] University of Texas – Pan American, United States
[b] East Carolina University, United States

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ABSTRACT

We examine the relation between corporate diversification, real earnings management, and firm value. Our analysis indicates that industrial diversification and the combination of industrial and global diversification exacerbate real activities manipulation, whereas global diversification mitigates it. The evidence also shows that real earnings management is inversely related to firm valuation, and that it influences the excess value ascribed to diversification. We find that the reduction in value caused by real activities manipulation is more pronounced among industrially diversified firms and among firms that are both industrially and globally diversified, but not firms that are only globally diversified. Consequently, as the extent of real earnings management increases, the discount associated with industrial diversification becomes larger. These findings help to explain why some diversified firms have lower valuations not only across different diversification profiles, but also within the same diversification category. Our results also reconcile past literature by helping to explain discrepancies in previous findings. Therefore, our study provides a more unifying view of how the diversification discount can vary among firms and how it can change over time.

* Corresponding author at: East Carolina University, 1001 East 5th Street, Greenville, NC 27858, United States. Tel.: +1 9544711869.

E-mail addresses: jfarooqi@utpa.edu (J. Farooqi), harriso@ecu.edu (O. Harris), ngotn123@gmail.com (T. Ngo).

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1. Introduction

Whether corporate diversification exacerbates or mitigates earnings management is a topic of continuing debate. For instance, Lim et al. (2008), Rodríguez-Pérez and Hemmen (2010), and Chin et al. (2009) find a positive relation between discretionary accruals and firm diversification, implying that earnings management is more severe in diversified firms. Their finding supports the view that corporate diversification increases information asymmetry by way of greater size and complexity, which managers exploit to manipulate earnings. In contrast, Jiraporn et al. (2008) argue that corporate diversification reduces earnings management because diversified firms generate uncorrelated cash flows from varied sources that offset accruals. They report that discretionary accruals decrease with industrial diversification, as well as with a combination of industrial and global diversification, but not with global diversification alone. El Mehdi and Seboui (2011) argue that industrial diversification mitigates accrual manipulation while global diversification exacerbates it.

However, while managers may use accounting maneuvers to manage earnings, they also manipulate earnings through real economic actions that change the timing or structuring of an operation, investment, or financing transaction (Graham et al., 2005; Badertscher, 2011; Zang, 2012). Yet, earlier studies focus exclusively on relating diversification to accrual management. Notwithstanding, several studies provide evidence that managers cut discretionary spending, sell fixed assets, postpone new projects, use sales manipulation, and engage in overproduction to manipulate their reported earnings (Baber et al., 1991; Dechow and Sloan, 1991; Bartov, 1993; Bange and De Bondt, 1998; Bens et al., 2002; Thomas and Zhang, 2002; Cheng, 2004; Graham et al., 2005; Roychowdhury, 2006).

Cohen et al. (2008) and Badertscher (2011) suggest that firms use operational activities and accrual manipulation as substitutes. In fact, Zang (2012) finds a sequential substitutive relationship between the two strategies, wherein managers adjust discretionary accruals at fiscal year-end based on the outcome of their real activities manipulation during the fiscal year.[1] She shows that an unexpectedly high (low) level of real activities manipulation is directly offset by a lower (higher) level of abnormal accruals, indicating that decisions to manage earnings through real economic actions are made before decisions to manage earnings through accruals.

To date, only limited research has been done on the relationship between corporate diversification and operational activities to manage earnings. This is a significant oversight because real activities manipulation is quite pervasive, as documented by Gunny (2010), Cohen and Zarowin (2010) and Zang (2012). Consequently, previous studies are missing critical information that may lead to spurious conclusions about the relation between corporate diversification and earnings management. To the extent that real activities manipulation precedes accrual manipulation (see Zang, 2012), the relation between diversification and discretionary accruals may be illusory given that accounting manipulation is possibly a secondary earnings management tool. This observation may help to explain why the prevailing research on the topic finds mixed results.

The literature also suggests that real activities manipulation is harder to detect than accrual manipulation because real earnings management can be disguised as sincere "operating" business decisions (Gunny, 2010; Li et al., 2012). Graham et al. (2005) point out that while auditors can second-guess a firm's accounting practices, they cannot challenge real economic actions taken in the ordinary course of business to meet earnings targets. So naturally, after the passage of the Sarbanes-Oxley Act (SOX), managers shifted away from accounting maneuvers to manipulate reported earnings to more operational activities because of the enhanced regulatory scrutiny of financial reports by auditors and regulators (Cohen et al., 2008).

[1] Since real activities manipulation changes the timing and/or structuring of business transactions, such actions have to take place during the fiscal year. However, after the fiscal year-end but before the earnings announcement date, managers can adjust accruals. Thus, when managers observe the impact of real activities manipulation on earnings at fiscal year-end, they can offset an unexpectedly high (low) impact by using less (more) accrual management.