



Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

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



Accrual-based and real activity earnings management at the back door: Evidence from Chinese reverse mergers☆



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ARTICLE INFO

Article history:

Received 30 May 2014

Accepted 26 January 2015

Available online 31 January 2015

JEL classification:

G30

G34

M41

Keywords:

Earnings management

Reverse merger

Accrual-based manipulation

Real activities manipulation

Firm performance

ABSTRACT

We examine how Chinese reverse merger (RM) firms trade off and conduct income-increasing earnings management through accrual-based and real activities manipulation strategies. We find that Chinese RM firms engage in both real activities and accrual-based manipulation at higher levels than non-Chinese RM firms, regular US firms and other Chinese US-listed firms. Further analysis suggests that Chinese RM firms use real activities and accrual-based manipulation as substitutes and tend to transition to real activities management in the years after a reverse takeover. Big 4 auditors can effectively constrain both real activities and accrual-based earnings management in Chinese RM firms. We also find that accruals manipulation is more costly relative to real activities management in the short term because it predicts changes in post-acquisition operating performance in Chinese RM firms. Overall, the results provide practical implications to regulators, investors and auditors on the channels through which Chinese RM firms manipulate earnings and the economic consequence of those manipulations.

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☆ We are grateful for suggestions from Balasingham Balachandran (the editor), an anonymous reviewer, Martin Bugeja, Peter Easton, Jere Francis, Wen He, Wei Jiang, Zoltan Matolcsy and Stephen Taylor, as well as workshop participants at the University of Technology Sydney and East China Normal University. We also appreciate the research assistance of Dongjuan Zang, Yuxing Hou, Sheng Guo, Jiaqi Ren, Zhuoli Wang and Jiaye Zhang. Tingting Zhu gratefully acknowledges the work sponsored by Shanghai Pujiang Program (No. 12PJJC042), and Yaowen Shan acknowledges the support received from a UTS Business School research grant.

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<http://dx.doi.org/10.1016/j.pacfin.2015.01.008>

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1. Introduction

The recent accounting crisis and the market collapse of US-listed Chinese companies have attracted extensive media coverage, shareholder concerns and regulatory attention. The concerns are particularly focused on Chinese firms listed in the United States through reverse mergers (RMs). In these mergers a publicly traded US firm is acquired by a Chinese private firm, which subsequently controls the combined business and goes public in the US market. In June 2011, the US Securities and Exchange Commission (SEC) issued an investor warning related to the accounting and disclosure practices of Chinese RM firms. Further regulatory actions by the SEC, the NASDAQ and the New York Stock Exchange (NYSE) resulted in more than 30 Chinese RM firms being subject to suspended trading, halted trading or delisting for various reasons. New rules were also adopted to toughen the standards for RM companies.¹

In this study, we examine how Chinese RM firms trade off and conduct two distinct behaviors for income-increasing earnings management, namely accrual-based earnings management (AEM) and real activities earnings management (REM), at the “back door”.² Chinese RMs present a unique setting for understanding earnings management. While prior research extensively documents earnings management in initial public offerings (IPO),³ recent studies argue that the evidence is driven by measurement errors in discretionary accruals arising from the investment of IPO proceeds in working capital (Armstrong et al., 2012; Ball and Shivakumar, 2008; Cecchini et al., 2012). In contrast, reverse merger, as an alternative way of going public, does not raise capital by issuing stocks. Consequently, tests of earnings management around RMs are not undermined by the measurement errors identified in IPOs arising from the investment of raised funds (Ball and Shivakumar, 2008). Thus, our study adds to the IPO literature and provides novel data on income-increasing earnings management behaviors of firms around the time of going public.

In addition, examining Chinese RMs also enables conducting powerful tests on earnings management. Unlike regular US firms listed through an IPO, an RM bypasses regulatory requirements set for IPO firms and does not require the support of underwriters who monitor the IPO process. The lack of underwriter monitoring and less stringent regulation requirements in the process of reverse acquisition increase earnings management opportunity in Chinese RM firms (Feldman, 2009; Lee and Masulis, 2011). Moreover, a typical RM firm tends to have relatively low fundamental quality and a high degree of information asymmetry (Adjei et al., 2008; Gleason et al., 2005). Compared with regular US firms and other Chinese US-listed firms, Chinese RM firms with inferior fundamentals have higher incentives and greater opportunity to manage earnings in the years around reverse acquisition to boost stock prices, sustain overvaluation or increase the probability of raising capital in the future.

Finally, the background for Chinese RM firms is a transitional economy without a tradition of transparency and effective legal enforcement. In contrast, other RM firms mostly originate in countries with strong legal enforcement and regulations such as the United States, United Kingdom and Canada (more than 90% of the sample). Ball et al. (2003) and Leuz et al. (2003) find that the extent of earnings management tends to be greater in firms from countries with weak legal enforcement. In addition, He et al. (2012) argue that the US stock exchanges and information intermediaries have become lax in screening Chinese firms for listing in recent years, leading to the selection of a large group of Chinese RM firms with inferior quality in corporate governance. Since good corporate governance serves as an effective mechanism to alleviate income-increasing earnings management behaviors (Cornett et al., 2008; Hazarika et al., 2012; Laux and Laux, 2009), Chinese RM firms with ineffective governance structure are more likely to engage in earnings manipulation.

We examine two distinct channels of income-increasing earnings manipulations. Accrual-based earnings management involves managerial intervention in the financial reporting process via accounting choices and estimates under generally accepted accounting principles (GAAP). In contrast, real activities earnings management involves managers taking actions that have cash flow consequences, such as adjusting the timing or scale of the firm's operating, investing and/or financing transactions. Examples of real activities

¹ On November 8, 2011, the NYSE and NASDAQ, with the approval of the SEC, adopted new rules that toughen the standards for RM companies. Under these rules, a RM company that wants to apply for listing on a US stock exchange is required to (1) complete a one-year “seasoning period” following the RM; and (2) file all required reports with the SEC, including an audited financial statement.

² Throughout this study, we use accrual-based earnings management, accrual-based manipulation, accruals earnings management, and accruals manipulation interchangeably. We also use real activities earnings management, real activities manipulation and real activities management interchangeably.

³ See for example, Teoh et al. (1998a, 1998b), Teoh and Wong (2002), Morsfield and Tan (2006), and Fan (2007).

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