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Do firms mislead investors by overstating earnings before seasoned equity offerings?☆

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Abstract

I examine earnings management around seasoned equity offerings and, consistent with Rangan (J. Financial Econ. 50 (1998) 101) and Teoh et al. (J. Financial Econ. 50 (1998) 63), find evidence of earnings management around the offerings. However, in contrast to their conclusions, I show that investors infer earnings management and rationally undo its effects at equity offering announcements. The investor naïveté conclusion of Teoh et al. (J. Financial Econ. 50 (1998) 63) and Rangan (J. Financial Econ. 50 (1998) 101) appears to be due to test misspecification. I conclude that seasoned equity issuers' earnings management may not be designed to mislead investors, but may merely reflect the issuers' rational response to anticipated market behavior at offering announcements. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

Earnings management around firm-specific events has received considerable attention from researchers in recent years.[1] These studies typically examine managers' reporting behavior around specific corporate events, and conclude that evidence of earnings management is consistent with managerial opportunism. However, relatively little is known about investor response to earnings management, particularly following firm-specific news releases that should alert investors to such earnings management. This paper examines both managerial reporting behavior and investors' response around public offerings of common stock. The results suggest that earnings management is explained by a rational expectations model at least as well as by managerial opportunism.

I hypothesize that managers overstate earnings before announcing seasoned equity offerings, and that an offering announcement reveals this overstatement to market participants. Thus, on the announcement of an equity offering, investors lower their assessments of prior earnings surprises, and rationally discount firm value. The average price drop at the announcements of seasoned equity offerings is consistent with this investor conditioning process.

At first glance, the above hypothesis appears paradoxical. Why would issuing firms engage in earnings management if investors undo its effects at offering announcements? I argue that earnings management before equity offerings is not intended to mislead investors, but is instead the issuers' rational response to anticipated market behavior at offering announcements. Since issuers cannot credibly signal the absence of earnings management, investors treat all firms announcing an offering as having overstated prior earnings, and consequently discount their stock prices. Anticipating such market behavior, issuers rationally overstate earnings prior to offering announcements, at least to the extent expected by the market. Earnings management by issuers and the resulting discounting by investors is a unique Nash equilibrium in a prisoner's dilemma game between issuers and investors. I refer to this argument for earnings management as the 'Managerial Response' hypothesis.

A secondary objective of this paper is to reexamine the evidence presented in two recent studies by Rangan (1998) and Teoh et al. (1998). Rangan (1998) and Teoh et al. (1998) investigate whether earnings management before seasoned equity offerings causes the poor long-run stock performance following equity offerings, which originally appears in Loughran and Ritter (1995) and Spiess and Affleck-Graves (1995). Both Rangan and Teoh et al. hypothesize that investors fail to recognize earnings management at the time of equity offerings and naively

[1] For example, DeAngelo (1986), Perry and Williams (1994) (around management buy outs), Aharoney et al. (1993) (around initial public offerings), and Erickson and Wang (1999) (around stock-for-stock mergers).

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