Earnings management and the market performance of acquiring firms

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Abstract

I examine the market’s efficiency in processing manipulated accounting reports and provide an explanation for the post-merger underperformance anomaly. I find strong evidence suggesting that acquiring firms overstate their earnings in the quarter preceding a stock swap announcement. I also find evidence of a reversal of the stock price effects of the earnings management in the days leading to the merger announcement. However, the pre-merger reversal is only partial. I find evidence of a post-merger reversal of the stock price effects of the pre-merger earnings management. The results suggest that the extent evidence of post-merger underperformance by acquiring firms is partly attributable to the reversal of the price effects of earnings management. The study also suggests that the post-merger reversal is not fully anticipated by financial analysts in the month immediately following the merger announcement. However, consistent with suggestions in the financial press that managers guide analysts’ forecasts to “beatable” levels, the effect of the earnings management reversal seems to be reflected in the consensus analysts’ forecasts by the time of the subsequent quarterly earnings releases.

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1. Introduction

This study examines the market’s efficiency in processing manipulated accounting reports and provides an explanation for the post-merger underperformance anomaly. Prior studies find that acquirers experience significant losses in the years subsequent to a merger announcement. Jensen and Ruback (1983, p. 20), who review this literature, comment that the “post-outcome negative abnormal returns are unsettling because they are inconsistent with market efficiency and suggest that changes in stock prices during takeovers overestimate the future efficiency gain from mergers.” Through an examination of the effects of earnings management on the performance of acquiring firms, I find that the reversal of the effects of pre-merger earnings management is a significant determinant of both the short-term and the long-term performance of stock-for-stock acquirers.

Consistent with Erickson and Wang (1999), I find strong evidence suggesting that acquiring firms overstate their earnings reports in the quarter preceding a stock swap announcement. Erickson and Wang (1999) postulate that the market expects a firm to inflate its earnings prior to a stock swap and, consequently, discounts its stock price at the announcement of the stock swap whether the firm manages earnings or not. Anticipating this market behavior, an acquirer’s best response is to manage earnings. Consistent with rational market expectations, Shivakumar (2000) finds a significant negative correlation between a firm’s discretionary accruals and the market reaction to the announcement of a seasoned equity offering (SEO).

In this study, I find no evidence that the market reaction over the three days around a merger announcement is negatively correlated with acquirers’ abnormal accruals. This apparent contradiction with Shivakumar (2000) likely stems from differences in the process leading to a merger as opposed to an SEO. A merger is the result of negotiations between an acquirer and a target, while an SEO involves only the issuing firm. Therefore, because of the negotiation process between the merging partners that is inherent in a merger, news leakage is more likely for mergers than for SEOs. This is consistent with results by Schwert (1996), for instance, who shows significant run-ups in targets’ prices as far back as one month (21 trading days) before a merger announcement. Hence, in a merger, the stock price adjustment is likely to start weeks before the merger announcement during the rumor phase of the merger. To accommodate this eventuality, I extend the event window one month prior to the merger announcement. Consistent with the rational expectations hypothesis, the correlation between the abnormal accruals and the abnormal returns of the acquiring firms that engage in stock swaps becomes significantly negative.

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1 Schwert (1996) shows the pre-merger run-up only for target firms. Palepu (1986) suggests that investors anticipate potential targets. However, investors are also likely to identify potential acquirers because news of impending mergers is usually leaked into the market well before the merger announcement. The Security Data Company’s online database of mergers and acquisitions, for instance, has a sample of merger rumors in which both the targets and the bidders are identified.
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