



Using financial accounting information in the governance of takeovers: An analysis by type of acquirer

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Abstract

The substantial changes in the corporate governance mechanism of acquired firms that take place during the periods surrounding corporate acquisitions lead investors and other corporate financiers to an intensive search for financial accounting inputs for decision making. We examine whether financial accounting information on takeover targets provides useful input in the corporate governance mechanisms of US publicly traded takeovers in these periods. Our analysis is by four different types of acquirers: foreign firms, publicly traded US firms, private US acquirers, and leverage buyouts (LBOs). We expect that certain firm-specific financial accounting characteristics of takeover targets by type of potential acquirer affect valuation. To examine this expectation we construct a probability summary-value measure, composed of eight financial accounting variables, based on the type of acquirer. We also expect the probability

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summary-value measure to be useful for determining investment strategies in acquired firms. The empirical results strongly support our expectations.

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1. Introduction

During periods surrounding corporate acquisitions, the corporate governance mechanism of acquired firms changes substantially. In particular, new potential financiers such as the new investors and acquiring firms extensively scrutinize publicly available information in search of inputs. A major research question that has been partially ignored in prior literature is how relevant accounting information is during these periods. In these settings, financial accounting information may play a more prominent role in corporate governance mechanisms and should therefore have greater value relevance to investors and other financiers of the firm, increasing their demand for such information when making decisions.

In this study, we examine the value relevance of information available from the financial statements of US publicly traded acquired firms prior to the acquisition. Our focus is on the value relevance of the accounting information to different types of acquirers and other investors in target firms. We identify four types of acquirers: foreign firms, publicly traded US firms, private US acquirers, and leverage buyouts (LBOs).² We expect the accounting information of the acquired firms to differ across types of acquirers and provide different inputs and signals to investors. In addition, we expect that the accounting information is useful for investment strategy in choosing among acquired firms.

Extant accounting studies use earnings and book value of equities to explain prices and returns. Rather than focusing only on earnings and book values, which may not provide sufficient information at the end of the firm's life cycle, we construct a probability summary-value measure (Ou and Penman, 1989), composed of other components of accounting data. This measure includes specific characteristics of accounting information used by each type of potential major financier in the corporate governance of takeovers, and differs, on average, across acquired firms classified by the four types of acquirers.

² Bradley et al. (1988), Kim and Lyn (1991), Opler and Titman (1993), Barnes et al. (1996) and Gonzalez et al. (1998).

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