EARNINGS MANIPULATION IN ACQUIRING COMPANIES: AN OVERVIEW

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ABSTRACT

This study addresses earnings manipulation actions under certain circumstances. Many studies have shown that bidding companies experience abnormal negative returns after undertaking bids. This anomaly requires an explanation from an accounting perspective, as a linkage between accruals and stock returns would yield insight into such observations. This paper addresses earnings manipulation in general and in the context of takeover bids, describes potential factors related to mergers and acquisitions, and suggests a methodology to provide empirical evidence to explain the decline in bidding companies' performance post takeover that causes abnormal negative returns. This study seeks to extend earnings manipulation studies using a takeover perspective and suggests a link between accounting policies around a takeover and stock return behaviour during the same period.

Keywords: Earnings management, Accounting Policies, Efficient Market Hypothesis, Mergers and Acquisitions.

INTRODUCTION

There is an understanding among many accounting researchers (e.g. Healy 1985, DeAngelo 1986, and Jones 1991) and among users of financial statements that management deliberately manipulates earnings for certain events. (Healy 1985) studies the earnings manipulation assuming that the management compensation plans is the incentive for this action, (DeAngelo 1986) argues that the motivation buyout, and (Jones 1991) assumes that tax relief is the motivation. Earnings manipulation is assumed to be a practice employed by management in pursuit of self-interest either by selecting accounting procedures or by manipulating accruals in order to increase or decrease reported earnings. Certain economic and contractual variables provide an additional incentive for this practice. In addition to afore mentioned studies, (Defond and Jiambalvo 1994) suggest that debt contracts provide management with incentives to manipulate earnings. This approach does not violate the perspective that managers, on average, smooth earnings to enhance their quality. The studies of (Subramanyam 1996) and (Chaney et al 1996), among others, indicate that managers, on average, smooth income to enhance the quality of earnings. (Shubita 2011) reveals mixed results for income smoothing in the Gulf Corporation Council Capital Markets. This study will provide a review of the motivations for earnings manipulation under certain circumstances. The event that will be analyzed is merger and acquisition.

The remainder of this study is organized as follows. Section 2 discusses the incentives of managers prior to takeover bids. Section 3 discusses consequences of earnings manipulation for bidder companies. Section 4 presents additional factors to explain earnings manipulation prior to takeover bids. Finally, section 5 contains a summary and conclusions.

DISCUSSION OF MANAGERS' INCENTIVE TO MANIPULATE ACCRUALS PRIOR TO TAKEOVER BIDS

Acquiring another company can be considered a major strategic decision for the acquiring company. Thus, it requires the management of the acquiring company to prepare in advance before making a decision to undertake a bid. It is unlikely that such an important decision will be undertaken without sound and early planning. Managers of acquiring companies, like all rational managers, seek to minimise the cost of bids as much as possible to benefit their company and its shareholders, as this will reduce the cost of the financing operation.

There have been several UK studies, in addition to many other international studies, that have investigated the stock market performance of acquiring companies around takeover bids. (Gregory 1997) examines the long-term performance of UK acquiring companies after a takeover. His results indicate that the post-takeover performance of acquiring companies is unambiguously negative, particularly in the case of equity offers. His explanation for this observation is that acquiring companies use over-valued equity to buy target companies. Further, he contends that share-for-share acquisition is simply one way of issuing over-valued equity to the market. Moreover, (Limmack 1991) shows that bidder companies obtain positive abnormal returns in the six months before bid announcement. On the other hand, bidding companies obtain negative returns for the post-bid period. Further, (Limmack 1991) demonstrates that the outcome of the bid does not have an impact on the trend of the results. In the same vein, (Franks and Harris 1989) show that bidding companies achieve negative returns for the post-bid period.

In summary, existing evidence indicates that bidding companies achieve positive abnormal returns in the pre-bid period and negative abnormal returns in the post-bid period, regardless of the outcome of the takeover bid (Limmack 1991). (Dechow et al 1996) found that, among other motivating variables, the most important motivation for management to manipulate earnings is the desire to attract external financing at a low cost. As indicated earlier, acquiring another company involves a financing decision, and when one takes into account the findings of (Dechow et al. 1995) that the main incentive for manipulating earnings is to reduce financing costs, it is clear that there is a great motivation for the managers of bidding companies to increase their earnings prior to takeover bids by opportunistically manipulating their accruals in order to convince the market that their companies are performing efficiently. This is done with a view to boosting their share price in order to allow them to finance their companies at lower cost by acquiring other companies using overvalued shares. A potential consequence of such manipulation is that accruals are expected to reverse in the following years (the bidding year and subsequent years). Accrual manipulation prior to takeover bids and its reversal after making bids may provide an explanation for the recent positive returns for bidding companies prior to takeovers and abnormal negative returns for the post-bid period.

The recommended approach that could be adopted as the methodology of this event study is that of (Defond and Jiambalvo 1994). The argument here is that managers of acquiring companies plan in advance for takeover by boosting reported earnings, particularly, in the year immediately preceding the takeover. This may explain the findings of (Limmack 1991) that bidding companies achieve abnormal positive returns for the pre-bid period as a result of positive earnings manipulation in an effort to fool the market. Consequently, the increase in accruals will be reversed (offset) in the following year(s); this may explain why bidding companies achieve abnormal negative returns for the post-bid period, as accrual reversal occurs due to the technical requirements of double-entry accounting. The market thus revises its expectations downwards by having negative returns in the post-bid period as a reaction to the decline in earnings after the takeover. This scenario provides a logical accounting explanation for the results of the (Gregory 1997) study.

CONSEQUENCES OF EARNINGS MANIPULATION FOR BIDDER COMPANIES

Madura and Wiant (1994) analyzed abnormal returns of acquiring companies over the long term after a takeover. They found that, in a US sample of 152 acquisitions taking place between 1983 and 1987, average cumulative abnormal returns of acquires were negative during the 36-month period following the merger announcement. Additionally, abnormal returns were negative in nearly every month. Acquirer losses around the time of the announcement may reflect a loss of wealth from an overly generous merger price. Negative abnormal returns in months after the announcement may be due to the market revising its expectations for the merger downwards. The clear results of (Madura and Wiant 1994) support the conclusion reached by (Gregory 1997), Limmack (1991), and (Franks and Harris 1989), as mentioned earlier.

The clear evidence regarding negative abnormal returns for bidding companies post-takeover raises the question of the reason. In light of the Efficient Market Hypothesis (EMH) that indicates that share price is a valid and creditable benchmark for company performance, and in light of the market mechanism to detect any manipulation, a potential explanation for negative returns is that the reported Earnings per Share of the bidding companies is an inflated figure used chiefly to convince the target shareholders to accept the takeover offer. This explanation is predicted on the assumption that the managers of bidder companies plan for the takeover ahead of time by utilizing discretionary accruals to inflate earnings. Based on the EMH, such behavior cannot continue over the long run. Furthermore, the accruals' nature is to reverse to correct any manipulation-inflated action(s) based on accruals.

The linkage between the negative abnormal returns for the post-bid period that have been revealed in many studies mentioned previously and the accrual-based studies that indicate the possibility of earnings manipulation, especially under certain circumstances, shows that there is a chance to employ accruals to manipulate earnings prior to the takeover bid in order to minimize financing costs.

ADDITIONAL FACTORS TO EXPLAIN EARNINGS MANIPULATION PRIOR TO TAKEOVER BIDS

Following the discussion in the previous sections, one may assume that the takeover event is sufficient motivation for earnings manipulation. Thus, it is quite important to consider additional factors associated with the takeover event that may lead to better understanding of the management behavior of bidding companies prior to takeover bids.

The following list describes additional factors that may explain to extend of earnings manipulation prior to takeover bids and the expected trend of the relationship between these factors and the engagement of earnings manipulation:

Type of offer:-

This factor is expected to have an impact on the extent of earnings manipulation by the management of a bidding company prior to a takeover bid. Based on the analysis of the Datastream listing of the takeover, the most common offer types are the following:

- Cash offer
- Equity offer
- Cash offer with equity alternative
- Equity offer with cash alternative

Gregory (1997) shows that negative abnormal returns were significant in the case of equity offers. Thus, considering the type of offer enables a better understanding of manipulation pre- and post-takeover.

Outcome of offer:-

Offers may be classified as either:

- Successful or
- Unsuccessful

Despite the finding in studies that abnormal returns in the post-bid period did not indicate clear evidence of any differences due to the outcome of the bid, this factor should be considered, as the outcome of the bid is expected to be a function of the preparation for the bid.

Attitude of the offer:-

Takeover bids can be classified as either:

- Friendly or
- Hostile

Martynova and Renneboog (2006) describe greater price reaction for a hostile takeover compared to a friendly offer. Thus, it is worth investigating the potential impact of this factor on the extent of earnings manipulation.

Value of the offer:-

Finally, the value of the bid may explain the motivation for earnings manipulation. In this regard, it is expected that the extent of earnings manipulation is higher when the value of the bid increases.

Overall, the above factors may support the initial argument in this section that the managers of bidding companies manipulate accruals prior to takeover bids. As a consequence of this manipulation, results show that there is a decline in unexpected accruals in the post-bid period. Such an argument may explain the positive abnormal returns in the six months before bid announcement for bidding companies, as noted by (Limmack 1991), as well as later negative, as presented in most of the studies in this field (as discussed previously).

SUMMARY AND CONCLUSIONS.

This study provides theoretical background for earnings manipulation based on a small-sample approach. The major advantage of the sample is in providing a methodology of analysis based on a homogeneous sample with an event that gives the manager the incentive to manipulate accruals in order to reduce external financing costs. Further, this study provides the expected trend of the results.

Other potential factors have been presented in order to provide better explanations of earnings manipulations prior to takeover. These factors are the type of offer, attitude of the offer, outcome of the offer, and value of the offer.

In the further, it is recommended that researchers seek a link between stock-returns behaviour and accounting policy based on accruals around takeover bids.

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