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An Examination of Earnings Management by Publicly Listed Targets Ahead of Mergers and Acquisitions

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Abstract : This paper examines accrual and real earnings management by publicly listed targets around mergers and acquisitions. Prior literature shows that earnings management around mergers and acquisitions can have a significant economic impact because of the associated wealth transfers among stakeholders. More importantly, acting on behalf of their shareholders or pursuing their self-interests, managers of both targets and acquirers may be equally motivated to manipulate earnings prior to an acquisition to generate higher gains for their shareholders or themselves. Building on the grounds of information asymmetry, agency conflicts, stewardship theory, and the revelation principle, this study addresses the question of whether takeover targets employ accrual and real earnings management in the periods prior to the announcement of Mergers and Acquisitions (M&A). Additionally, this study examines whether acquirers are able to detect targets' earnings management, and in response, adjust the acquisition premium paid in order not to face the risk of overpayment. This study uses an aggregate accruals approach in estimating accrual earnings management as proxied by estimated abnormal accruals. Additionally, real earnings management is proxied for by employing widely used models in accounting and finance literature. The results of this study indicate that takeover targets manipulate their earnings using accruals in the second year with an earnings release prior to the announcement of the M&A. Moreover, in partitioning the sample of targets according to the method of payment used in the deal, the results are restricted only to targets of stock-financed deals. These results are consistent with the argument that targets of cash-only or mixed-payment deals do not have the same strong motivations to manage their earnings as their stock-financed deals counterparts do additionally supporting the findings of prior studies that the method of payment in takeovers is value relevant. The findings of this study also indicate that takeover targets manipulate earnings upwards through cutting discretionary expenses the year prior to the acquisition while they do not do so by manipulating sales or production costs. Moreover, in partitioning the sample of targets according to the method of payment used in the deal, the results are restricted only to targets of stock-financed deals, providing further robustness to the results derived under the accrual-based models. Finally, this study finds evidence suggesting that acquirers are fully aware of the accrual-based techniques employed by takeover targets and can unveil such manipulation practices. These results are robust to alternative accrual and real earnings management proxies, as well as controlling for the method of payment in the deal.

Keywords : accrual earnings management, acquisition premium, real earnings management, takeover targets
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