Market perceptions of discretionary accruals by debt renegotiating firms during economic downturn

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Abstract

This study addresses how a stock market prices earnings components around a sudden and severe economic downturn. In particular, the study examines the market valuation of discretionary accruals for debt renegotiating Malaysian firms during the Asian financial crisis. Our analysis shows that negative discretionary accruals for debt renegotiating firms are associated with higher market values of equity and are not related to the firms' future earnings. These findings are consistent with investors placing a positive value on the probability that negative accruals increase the likelihood that concessions can be extracted from lenders during renegotiation. In contrast, discretionary accruals for a control sample of non-debt renegotiating firms are not significantly associated with stock prices but are positively associated with future earnings.

Introduction

Prior research confirms that accruals have incremental information content in explaining share prices and that accruals ability to predict future cash flows is incremental to the predictive ability of past cash flows (Bowen et al., 1987, Dechow, 1994, Dechow et al., 1998, Pfeiffer et al., 1998). However, while the market values accruals positively when managers convey a credible signal of their private information about firms' future profitability, the market may value accruals negatively or ignore them if investors believe that managers use accruals to disguise the underpinning economic performance of the firm (Schipper, 1989, Holthausen, 1990, Healy and Palepu, 1993).

In this paper, we exploit a unique opportunity and database to investigate the capital market perception of financially distressed firms' discretionary accruals during a sudden and severe economic downturn. More specifically, we examine the market valuation of the discretionary accruals of Malaysian listed firms that
undertook debt renegotiations following actual debt default during the Asian financial crisis and compare this with a set of similarly poor performing firms that did not undertake debt renegotiations. The uniqueness of the sample and the temporal and national setting limits the generalizability of our findings. More importantly, though, it contributes to the internal validity of assessing perceptions of capital market participants of financially troubled firms’ discretionary accruals when the general economic climate becomes suddenly and severely adverse.

Consistent with prior research, we debate two conflicting theoretical arguments. If signalling theory applies, investors consider that discretionary accruals signal private information regarding the firm's future performance and the association between discretionary accruals and market value should be positive. An alternative view drawn from contracting theory is that investors expect managers to manage earnings to extract concessions from the lending agencies that might pull the firm out of its financial distress. In periods of poor performance, managers are more likely to be concerned about their firms’ survival in a sluggish economy than with maintaining a reputation for credible communication (see Warner et al., 1988, Weisbach, 1988, Fudenberg and Tirole, 1995). Therefore, incentives such as maximising concessions might dominate in these periods. If the market perceives that these incentives are dominant, then the relation between market value and discretionary accruals should be negative (Gul et al., 2000, Balsam et al., 2002).

Watts and Zimmerman (1990) and Holthausen (1990) explain the signalling perspective and two contracting perspectives in detail to differentiate opportunistic and efficient contracting. Although we describe the motivations for earnings management, we are more concerned with its effects, which we do not necessarily attribute as being opportunistic or efficient because of the empirical difficulty of distinguishing the contracting incentives. We also believe that it is difficult to distinguish the opportunism and efficiency contracting perspectives because the outcome could be consistent with one contracting perspective but managers’ motivations might be consistent with another (e.g., ex ante, if managers aim to transfer funds from lenders to shareholders this is opportunistic in relation to the debt contract.

Using a large sample of 21,135 firm-years over 1973–93, Subramanyam (1996) finds that both stock returns and future profitability are associated with discretionary accruals. Subramanyam’s results are consistent with the signalling hypothesis that discretionary accruals convey credible information and improve the ability of earnings to reflect firms’ economic value. Xie (2001) extends Subramanyam (1996) and reports that the market overprices discretionary accruals relative to their association with one-year ahead earnings. He concludes that the overpricing of discretionary accruals is attributable to placing value on managerial discretion. However, neither study addresses whether the market responds differently to discretionary accruals under different circumstances. When Gul et al. (2000) investigate this issue, they examine the valuation of discretionary accruals of high growth and high debt U.S. firms. They report that discretionary accruals of high growth firms are more predictive of future profits than the discretionary accruals of low growth firms. In contrast, discretionary accruals of high debt firms are less predictive of future profits than do the discretionary accruals of low debt firms.

Ahmed and Zhou (2000) find that U.S. firms’ earnings multiples are significantly higher for large income increasing discretionary accruals than for small discretionary accruals. However, the effect of income decreasing discretionary accruals depends on the reporting firm's current performance. For high-performing firms, earnings multiples are significantly lower for large income decreasing discretionary accruals than for discretionary accruals. This is consistent with investors viewing the income decreasing discretionary accruals as transitory. In periods of low performance, however, earnings multiples are significantly higher for large income decreasing discretionary accruals than for small discretionary accruals.
Our study contributes to this strand of literature by examining two distinct samples: firms that have violated debt covenants due to financial distress and sought government or lender concessions in renegotiated debt agreements, and firms that experienced similar financial trouble without violating debt covenants. Our results show that discretionary accruals during the debt renegotiation periods are generally negative and associated with higher market values of equity for debt renegotiating firms, but not for non-renegotiating firms. Together, these findings suggest that market participants perceive that managers manage discretionary accruals to achieve government or lender concessions during debt renegotiation, consistent with Giammarino (1989). Additionally, future net earnings of these firms and their discretionary accruals are not significantly correlated during the debt renegotiation period, suggesting that managers of renegotiating firms did not use discretionary accruals to signal future earnings potential to the market.

The remainder of the paper is organised as follows. Section 2 describes the Malaysian institutional setting during the Asian Financial Crisis. Section 3 discusses the incentives of the managers of Malaysian firms undertaking debt contract renegotiations after violating debt covenants and of those firms not undertaking debt renegotiation, and develops the hypotheses. Research methods and data collection are described in section 4, followed by a discussion of the descriptive statistics and correlation structure in Section 5. The empirical results and the association between firms' discretionary accruals and their future performance are presented in Section 6. Section 7 summarises and concludes.

Section snippets

Institutional background: financial crisis and corporate debt during the economic crisis in Malaysia

Malaysia had an impressive record of economic performance during the 1980s. However, the country's economy began to suffer badly with the Asian financial crisis beginning mid 1997. The immediate impact was evident from a sharp decline in the value of the Malaysian Ringgit, GNP and stock market (Bank Negara Malaysia, 2000). During the crisis, total after tax earnings of listed non-finance-sector firms declined from RM25.5 billion in 1996 to RM22.5 billion in 1997 and further to RM-11.41 billion...

Hypothesis development

Evidence indicates that secured bank lenders usually make arrangements with borrowers to facilitate their financial difficulties during economic recessions (Asquith, Gertner, & Scharfstein, 1994). Accordingly, managers may have incentives to take advantage of information asymmetries and misrepresent their firms' values in order to extract maximum concessions from lenders during debt contract renegotiations (Bergman and Callen, 1991, Giammarino, 1989). DeAngelo, DeAngelo and Skinner (1994) argue ...

The valuation model

We apply a price model that uses the market value of equity (MVE) as the dependent variable and operating cash flows (OCF), non-discretionary accruals (NDAC), and discretionary accruals (DAC) as the independent variables for testing hypotheses one and two. We also include the book value of equity (BVE) in the regression model, following Barth, Beaver, and Landsman (1998a), Barth, Goster, Clement, and Kasznik (1998b) and Collins, Pincus, and Xie (1999). Following Easton (1998) and Ahmed and Zhou ...
Analysis of discretionary accruals

In Table 2 we investigate debt renegotiating firms' DAC behaviour three years prior to and one year following their renegotiations. For all models, DAC are positive in the third and second years preceding negative in the year immediately prior to debt renegotiation. The mean DAC of debt restructuring firms are $-0.189$, $-0.181$, $-0.123$ and $-0.119$ for models 1, 2, 3 and 4 respectively during year 0 (negotiation period), and all are significantly negative ($p<0.01$), consistent with Jaggi and Lee...

Discretionary accruals and future performance

Consistent with Subramanyam (1996) and Gul, Leong and Srinidhi (2000), we test our third hypothesis concerning whether future earnings are associated with the current period discretionary accruals of our financially distressed firms. In our tests, we regress one-year and two-year ahead operating incomes before taxation and regress them, separately for both the renegotiating and control samples in the following model

$$EBT_{t+k} = \alpha + \beta_1 BVE_{it} + \beta_2 OCF_{it} + \beta_3 NDAC_{it} + \beta_4 DAC_{it} + \epsilon_t$$

$k = 1, 2$

Where

$EBT$ = operating earnings...

Summary and conclusions

In this study, we use a unique Malaysian context to examine how the market prices discretionary accruals of two types of firms; (1) financially distressed firms that renegotiated debt, and (2) financially distressed Malaysian firms that did not renegotiate their debt contracts during a severe economic downturn. Based upon prior studies such as Subramanyam (1996) and Gul et al. (2000), we argue that discretionary accruals would be negatively associated with equity returns if the market perceives ...

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Earnings quality under financial crisis: A global empirical investigation
Lu (2012) found that a firm with lower earnings quality (higher accruals quality) has higher degree of risk-taking which is more significant after the 2008 financial crisis. Using a sample in Malaysia during 1997 Asian Financial Crisis, Ahmed et al. (2008) found that firms with potential debt renegotiations apply income decreasing management and the investors’ tolerance to poor financial performance is higher in the bad economic environment, so that firms book more accruals to depress earnings so as to improve performance after depression. Choi et al. (2011) analyzed the way the information value of reported revenues changed during the Asian financial crisis of 1997–1998.

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