



Do firms manipulate earnings before accelerated share repurchases?

Yung-Chin Chiu ^a, Woan-lih Liang ^b  

Show more 

 Share  Cite

<https://doi.org/10.1016/j.iref.2014.11.015>

[Get rights and content](#)

Abstract

This paper investigates whether firms engaging in accelerated share repurchases (ASRs) conduct downward earnings management prior to repurchase announcements. The ‘commitment’ and high ‘speed’ of share repurchases in ASRs appear to give ASR firms stronger incentive to deflate the pre-repurchase earnings than open market repurchase (OMR) firms, in order to reduce repurchase costs. However, in contrast to the OMRs of Gong, Louis, and Sun (2008), we do not find such earnings management for ASR firms. We conjecture that the Sarbanes–Oxley Act and greater public attention to financial reporting after financial scandals reduce the likelihood that ASR firms adopt accrual-based earnings management.

Introduction

This study explores a new and rapidly growing method of repurchasing shares: accelerated share repurchase (ASR).¹ An ASR is an innovation in which a firm buys back shares by entering into a forward contract with an investment bank. According to the Emerging Issues Task Force (EITF) Issue 99-7, an ASR program is a combination of treasury stock acquisition and forward contract. A treasury stock acquisition occurs when a firm buys back its own shares from the investment bank. The forward contract in an ASR obligates the firm to repurchase a specified number of shares from the investment bank over the contract period. A typical ASR transaction is shown in Fig. 1.

Similar to open market repurchases (OMRs), ASRs are corporate events and are used by firms to buy back outstanding shares. Sloan (1996) and Xie (2001) find that there is a negative relation between pre-event earnings manipulation and post-event abnormal return.² Similarly, using data from OMRs, Gong et al. (2008) find that firms' long run post-repurchase abnormal returns are driven by the pre-repurchase downward earnings management. Note that ASRs are also corporate events. Similar to OMRs, Barger, Kulchania, and Thomas (2011) and Chemmanur, Cheng, and Zhang (2010) find that firms with ASRs earn

positive long run post-repurchase abnormal returns.³ Thus, we conjecture that these positive abnormal returns after ASRs may be triggered by downward pre-repurchase earnings manipulation.

There are three views on the relationship between ASRs and pre-ASR downward earnings management. First, as Gong et al. (2008) suggest, the deflating pre-repurchase reported earnings are used to mislead the market to decrease the expected earnings and thereby effectively depress the repurchase cost (i.e. repurchase price). This lower repurchase cost resulting from downward earnings management can benefit managers because of the wealth transfers from the shareholders who sell shares to the remaining shareholders.⁴ This argument suggests that the managers have an incentive to deflate pre-repurchase reported earnings, especially when the firm wants to actually repurchase shares, because the firm must pay for repurchases. In addition, Gong et al. (2008) find the evidence that the downward earnings management only occurs for firms that 'actually' buy back shares 'shortly' after OMR announcements.⁵ Accordingly, the mechanism of ASRs that forces firms to actually buy back the pre-committed shares within one year induces managers conducting ASRs to deflate reported earnings before repurchases.⁶

Second, earnings management may be used to signal private information to the market which helps correct the valuation of the firms. Subramanyam (1996) finds that managers use accruals to improve information content. On this argument, overvalued firms may have incentive to conduct downward earnings management. Previous studies argue that firms with ASRs are more likely to be undervalued. Given that it is not possible to convey the messages of undervaluation and overvaluation at the same time, there may be no relation between ASRs and downward earnings management. Third, there may be no earnings management before ASRs because Sarbanes–Oxley Act (SOX) restricts the earnings management activity after 2004, and ASRs are implemented after 2004. In sum, the second and third views are generally alternative hypotheses to the first one, which proposes that there is a relation.

For the first view, we further consider that whether the market is misled by the downward earnings manipulation depends on whether investors are certain about the information content of the ASR.⁷ In contrast to OMRs, the commitment to an ASR should result in actual repurchase. Thus, investors face no uncertainty about repurchasing. However, the information content about the managers' incentives regarding ASRs remains uncertain for investors. Barger et al. (2011); Chemmanur et al. (2010) and Akyol, Shekhar, and Kim (2014) suggest that ASRs are used to convey favorable information such as the undervaluation and anti-takeover effects to the market. Managers who want to signal favorable information by ASRs are unlikely to deflate pre-repurchase earnings. Given the possible managers' incentives in making ASRs, investors are unable to determine which one is the actual incentive.⁸ In addition, investors cannot directly observe managers' actions. Thus, investors cannot correctly price the equity of ASRs, causing positive post-repurchase abnormal returns.⁹

To check whether the managers conducting ASRs have incentive to deflate the pre-repurchase reported earnings, we examine ASRs in the U.S. We hand-collect 202 ASR announcements in the U.S. using news retrieval from the Lexis–Nexis Academic and ABI/Inform databases for the period January 2004 to December 2008. We do not find that the actual repurchase ratio of ASRs is a determinant of abnormal accruals. This result implies that firms with higher repurchase ratios do not have stronger incentives to conduct downward earnings manipulation prior to repurchases. In addition, we do not find evidence to support the contention that post-repurchase stock returns are driven by the pre-repurchase downward earnings manipulation of ASRs. Thus, in contrast to the OMR study of Gong et al. (2008), we do not find that firms conducting ASRs engage in downward earnings management prior to the repurchase announcement.

Accordingly, we consider the second and third possible explanations for the lack of relationship between ASRs and downward earnings management. However, the second view does not seem to be a reasonable explanation of ASR events. First, corporate finance papers about ‘equity market timing’ (Alti, 2006, Baker and Wurgler, 2002, Graham and Harvey, 2001) show that managers tend to issue shares rather than buy back shares when the firm is overvalued.¹⁰ In addition, Jensen, 2004, Jensen, 2005 posits that managers of overvalued firms have pressure to engage in upward earnings management to prevent disappointing investors. Chi and Gupta (2009) and Marciukaityte and Varma (2008) find that overvaluation is statistically related to subsequent income-increasing earnings manipulation. Further, Sawicki and Shrestha (2008) find that insiders conduct downward earnings management when they buy shares and conduct upward earnings management when they sell shares. Thus, the second view implying that overvalued firms have incentives to conduct downward earnings management is controversial.

The third viewpoint could be the most relevant. Chen and Huang (2013) examine OMRs and show that downward earnings management disappears after SOX. Cohen, Dey, and Lys (2008) argue that public financial scandals of 2000 to 2002 caused investors to pay greater attention to financial reporting. Note that ASRs came into use in 2004, after SOX. Thus, SOX and greater public attention to financial reporting may result in non-significant downward earnings management of ASRs. In addition, previous studies identify managers' incentives for conducting ASRs. Barger et al. (2011) find that the managers have an incentive to use ASRs to signal undervaluation, adjust the capital structure, or reduce the possibility of takeovers. Akyol et al. (2014) find that conducting ASRs helps to reduce the likelihood of takeovers. Chemmanur et al. (2010) find that the undervaluation is the most reasonable explanation for firms to choose ASRs over OMRs. Accordingly, we conjecture that the absence of downward earnings management for ASRs may be derived from the SOX and other possible motivations such as undervaluation or anti-takeover.

Our paper contributes to the ASR literature as follows. First, though studies show that firms conduct earnings management “before” the corporate event (Teoh, Welch, & Wong, 1998 for initial public offerings; Gong et al., 2008 for repurchases), few papers examine the issue of whether firms conduct earnings management before ASRs. Thus, we fill this gap. Although Marquardt, Tan, and Young (2009) and Kurt (2010) also investigate the issue of ASRs and the earnings of repurchase firms, these studies are quite different from ours.¹¹ For example, Marquardt et al. (2009) show that the firms prefer ASRs to OMRs when repurchase is accretive to earnings per share (EPS) and when executive compensation is directly tied to EPS. They suggest that this finding, in which the short-term financial reporting is an important determinant of the adoption of ASRs, is an example of managerial myopia. Second, based on the commitment and immediacy of ASRs and the arguments of Gong et al. (2008), it is plausible that ASRs increase the attractiveness of downward earnings management prior to ASR announcements. However, we find no support for this argument because there appears to be no relationship between the post ASR long-run stock performance and pre-repurchase accruals, and no relationship between abnormal accruals and the actual repurchase ratio. Third, Gong et al. (2008) show that OMR firms tend to engage in prior repurchase downward earnings manipulation, but our study yields no such finding for ASR firms. We conjecture that the lack of significant pre-buyback downward earnings management of ASRs may stem from SOX and from the publicity surrounding the financial scandals of 2000 to 2002. Thus, our paper provides evidence for the usefulness of SOX.

The remainder of this paper is organized as follows. Section 2 describes the data and introduces the methodology. Section 3 presents the empirical findings on ASRs, including the descriptive statistics, regression analysis of pre-repurchase earnings management, and the regression of post ASR long-run stock performance. Section 4 summarizes the results of this paper.

Section snippets

Sample

We hand-collect U.S. ASR announcements using news retrieval from the Lexis–Nexis Academic and ABI/Inform for the period January 2004 to December 2008. We searched for ASR news using keywords such as “accelerated” and “repurchases”. Initially, we found 252 ASR events from 2004 to 2008. We exclude repurchasing firms with invalid Compustat/CRSP /EDGAR information and firms with a non-positive size, B/M ratio, or total assets. We also remove observations of American Depositary Receipts and...

Summary statistics

Table 2 reports the summary statistics for our ASR and OMR events. The average actual repurchase ratio of ASRs is greater than that of OMRs. In addition, the average size of ASR firms is larger than the average size of OMR firms, where the average size of ASRs is 8.6645 while that of OMRs is 6.2124. This result implies that although there are fewer ASRs than OMRs, the average size of the ASR firms is much larger than that of OMR firms. This finding is also consistent with Chemmanur et al. (2010)...

Conclusion

This study investigates this issue of whether firms with ASRs tend to deflate pre-repurchase earnings. The ‘commitment’ and high ‘speed’ of share repurchases in an ASR imply that the repurchasing cost could be a concern for the firm. Thus, to reduce the repurchase cost, it is plausible that a firm undertaking an ASR has a stronger incentive to deflate the pre-repurchase earnings than a firm undertaking an OMR. However, unlike the OMR findings of Gong et al. (2008), we do not find evidence that...

References (54)

B.M. Barber *et al.*

Detecting long-run abnormal stock returns: The empirical power and specification of test statistics

Journal of Financial Economics (1997)

L. Bargeron *et al.*

Accelerated share repurchases

Journal of Financial Economics (2011)

J. Chi *et al.*

Overvaluation and earnings management

Journal of Banking & Finance (2009)

E.F. Fama

Market efficiency, long-term returns, and behavioral finance

Journal of Financial Economics (1998)

E.F. Fama *et al.*

Common risk factors in the returns on stocks and bonds

Journal of Financial Economics (1993)

J.R. Graham *et al.*

The theory and practice of corporate finance: Evidence from the field

Journal of Financial Economics (2001)

C. Huang *et al.*

Firm age, idiosyncratic risk, and long-run SEO underperformance

International Review of Economics and Finance (2014)

D. Ikenberry *et al.*

Market under reaction to open market share repurchases

Journal of Financial Economics (1995)

K. Jung *et al.*

Timing, investment opportunities, managerial discretion, and the security issue decision

Journal of Financial Economics (1996)

S.P. Kothari *et al.*

Performance matched discretionary accrual measures

Journal of Accounting and Economics (2005)



View more references

Cited by (8)

Managerial compensation, product market competition and fraud

2016, International Review of Economics and Finance

Show abstract

Anticipation of takeovers in stock and options markets

2015, International Review of Economics and Finance

Show abstract

Exchange listing type and firm financial reporting behavior

2015, International Review of Economics and Finance

Show abstract

Accelerated share repurchases: value creation or extraction

2022, Review of Quantitative Finance and Accounting

Accelerated share repurchase and other buyback programs: what neural networks can bring

2020, Quantitative Finance

Accelerated Share Repurchase and other buyback programs: What neural networks can bring

2019, arXiv

Recommended articles (6)

Research article

[A quasi-bounded target zone model — Theory and application to Hong Kong dollar](#)

International Review of Economics & Finance, Volume 37, 2015, pp. 1-17

[Show abstract](#) ✓

Research article

[The friction-free weighted price contribution](#)

International Review of Economics & Finance, Volume 37, 2015, pp. 226-239

[Show abstract](#) ✓

Research article

[Optimal managerial hedging and contracting with self-esteem concerns](#)

International Review of Economics & Finance, Volume 37, 2015, pp. 354-367

[Show abstract](#) ✓

Research article

[Government insurance, information, and asset prices](#)

International Review of Economics & Finance, Volume 37, 2015, pp. 165-183

[Show abstract](#) ✓

Research article

[What determines the technology adoption of firms under optimal tax?](#)

International Review of Economics & Finance, Volume 37, 2015, pp. 274-289

[Show abstract](#) ✓

Research article

[Harvests' lifespan and North–South market share rivalry](#)

International Review of Economics & Finance, Volume 37, 2015, pp. 114-124

[Show abstract](#) ✓

[View full text](#)



Copyright © 2022 Elsevier B.V. or its licensors or contributors.
ScienceDirect® is a registered trademark of Elsevier B.V.

