

Accrual and real-based earnings management by UK acquirers

Evidence from pre- and post-Higgs periods

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Abstract

Purpose – This study aims to investigate the occurrence of pre-merger earnings management for a sample of 197 stock- and cash-financed UK acquirers between 1990 and 2009. It also examines the earnings management behaviour around the change in the Corporate Governance Code in 2003 based on the Higgs recommendations.

Design/methodology/approach – Mean and median accrual- and real-based manipulation are examined in the period before the announcement of a merger and acquisition. These are compared across stock and cash acquirers as well as before and after the implementation of the Higgs recommendations. Logistic regressions are also run to examine accrual- and real-based manipulation across stock and cash acquirers after controlling for variables that may affect the acquisition type.

Findings – The study found some evidence of upward pre-merger accrual-based earnings management by stock-financed acquirers, which is in line with the findings of Botsari and Meeks (2008). Furthermore, no significant changes were found in the post-Higgs period, which indicates that the recommendations put forth by Higgs may not have been successful in mitigating earnings management. The evidence also shows that cash bidders engage in pre-merger real earnings manipulation through lower discretionary expenses, possibly to enhance cash availability for the bid.

Practical implications – The findings in this study confirm earnings management exists around mergers and acquisitions and provide some evidence that the recommendations set out in the Higgs Report do not appear to have mitigated earnings management activities. This is of interest to regulators as well as investors and academicians.

Originality/value – This provides the first analysis in the UK examining the use of real-based earnings management activities by UK acquirers. It also extends prior research around corporate governance changes that occurred in the UK.

Keywords Corporate governance, Mergers and acquisitions, Earnings management

Paper type Research paper



1. Introduction

Earnings management has been extensively examined through a stream of research that considers firms involved in specific corporate events (such as seasoned equity offerings [SEOs], initial public offerings [IPOs] and management buyouts). This study extends prior

results on earnings management in mergers and acquisitions (hereafter M&As) that engage in either cash or stock bids and examines the prevalence of accrual- and real-based earnings management in this context. Furthermore, we examine whether regulatory changes in the UK following the Higgs (2003) Report have an impact on earnings management in this context.

Though prior research examined accrual-based manipulation in the M&A context in the USA (Erickson and Wang, 1999; Louis, 2004), the UK (Botsari and Meeks, 2008) and the Asia-Pacific region (Ardekani *et al.*, 2012; Higgins, 2013; Jeong and Bae, 2013), only limited studies extended its scope to examine whether acquiring firms engage in the manipulation of real activities (Zhang, 2015). Therefore, a comprehensive study that considers both accrual- and real-based earnings management practices is needed to contribute to earnings management research in the UK M&A context.

Furthermore, fundamental changes to governance codes around the world have occurred over the past few years. For example, the enactment of the Sarbanes–Oxley Act (SOX) in the USA; the UK Corporate Governance Code in the UK based on the recommendations set out in the Higgs (2003) Report, among others; and the governance reforms in Australia, through the “Corporate Governance Principles and Recommendations” (ASX, 2003, 2007, 2014). However, the effectiveness of those changes has not been empirically tested in the M&A setting. The crucial role of the Higgs (2003) Report in improving the Corporate Governance Code in the UK provides the motivation to investigate the prevalence of both accrual- and real-based earnings management activities in the period prior to and following the issuance of this report. Support for this analysis is driven by research that indicates the impact of governance characteristics and institutional settings on earnings management behaviour (Koh, 2003; Reverte, 2008; Epps and Ismail, 2009; Kent *et al.*, 2010; Bhuiyan *et al.*, 2013) as well as recent contributions to the UK literature that document the important effect of some corporate governance mechanisms raised by the Higgs (2003) Report in reducing earnings management activities (Iqbal and Strong, 2010; Habbash *et al.*, 2013a; 2013b).

The findings of the current study show some evidence of income-increasing pre-merger accrual-based earnings management by stock-financed acquirers in the full sample of years 1990–2009. However, there does not appear to be any changes across periods before and after the enactment of the Higgs recommendations. Furthermore, there is no evidence of manipulation by stock bidders using real activities either before or after the enactment of the Higgs recommendations, which indicate that M&As may not have shifted from accrual to real manipulation, as is the case in different settings in the USA.

On the other hand, cash bidders engage in pre-merger real earnings manipulation through mainly lower discretionary expenses, possibly to enhance cash availability for the bid.

When comparing stock and cash bidders, we find that stock bidders engage in income-increasing accrual manipulation more than cash bidders but mostly in the pre-Higgs period.

This study contributes to the literature in two ways. First, we provide the first analysis of the use of real-based earnings management by UK acquirers following the US empirical methodology (Roychowdhury, 2006; Cohen and Zarowin, 2010; Zang, 2012). Furthermore, we hypothesize and find different results for M&As financed by cash as well as stock. Second, this study conducts the first analysis of the effect of the Higgs Report in the M&A setting, by comparing the magnitude of pre-merger accrual- and real-based earnings management activities in pre- and post-Higgs periods.

The remainder of the paper is organized as follows. Section 2 reviews the prior studies in the M&A setting as well as those related to accrual- and real-based earnings management, especially in this setting. Building on the theoretical and empirical support of the literature, several hypotheses are developed. Section 3 discusses the empirical methodology including

the sample selection and earnings management measures. Section 4 presents and discusses the empirical results. The final section concludes the paper.

2. Related literature and hypotheses development

Historically, M&As in the UK have been prevalent and have tended to occur in cycles (Resende, 1999, 2008; Kastrinaki and Stoneman, 2013). Kastrinaki and Stoneman (2013) found evidence of long regular cycles in aggregate merger activities over the period 1969-2005, with each cycle lasting six years. They showed that these cycles of M&A activities are caused by economic factors such as fluctuations in stock prices, interest rates and gross domestic product growth (Kastrinaki and Stoneman, 2013). In essence, M&As are carried out by companies to achieve certain strategic and financial objectives that include market position improvement, geographic expansion, diversification and/or technological enhancement (Sudarsanam, 1995; Thompson *et al.*, 2004). Other motivations include disciplinary and undervaluation reasons (Raj and Forsyth, 2004).

Studies on M&As in the UK tend to examine the effectiveness and the impact of these activities in certain sectors, such as in hospitals (Haigh, 2000; Cereste *et al.*, 2003; Gaynor *et al.*, 2012) and in banks (Barnes, 1985; Haynes and Thompson, 1999; Saunders and Wilson, 1999; Piskula, 2011). However, results from these studies cannot be easily generalized to other sectors.

Studies in the UK that cover economy-wide M&A activities tend to focus on post-merger accounting returns (profitability) or short- and long-term effects on shareholder wealth of the acquirer or the target firm with mixed results. For example, some studies found that the profitability of UK acquiring firms consistently declines in post-merger years (Meeks, 1977; Dickerson *et al.*, 1997; Kumar, 1984). Other studies found post-merger increase in profitability in certain instances (Chatterjee and Meeks, 1996; Guest *et al.*, 2010). Furthermore, some studies found a negative impact on share returns for the acquirer firm (Barnes, 1984; Franks and Harris, 1989; Conn *et al.*, 2005), whereas others found a positive impact (Hodgkinson and Partington, 2008).

The mode of payment of the acquisitions is also an important consideration. Previous US and UK literature (Shleifer and Vishny, 2003; Sudarsanam and Mahate, 2003; Dong *et al.*, 2006; Akbulut, 2013) documented negative announcement returns earned by acquiring firms that use stock as a mode of payment and these equity-financed bids substantially underperform cash-financed ones. This is consistent with potential overvaluation of acquirers' stock, which is not fully corrected on the announcement date but rather destroys shareholder value both in the short and the long run.

However, few studies focused on examining accounting irregularities in acquirers before an M&A announcement, which can potentially explain mixed evidence of shareholder returns around M&As. An acquirer's motivation to manage earnings depends on the use of equity as a mode of payment because the market value of a share is affected by earnings management. The target's shareholders are concerned with the fair value of the acquirer's share, only if they have an ownership interest in the combined firm in exchange for their old shares. The following sections present current literature in this area conducted in other countries and propose the hypotheses for the current study.

2.1 Accrual-based earnings management in M&As

Several studies examined the occurrence of earnings management around major events in corporate finance. These events include SEOs (Rangan, 1998; Teoh *et al.*, 1998b; Shivakumar, 2000; Ching *et al.*, 2006; Iqbal *et al.*, 2009; Bardos and Zaiats, 2012; Dionysiou, 2015), IPOs (Teoh *et al.*, 1998a; Teoh *et al.*, 1998c; Teoh and Wong, 2002; Chang *et al.*, 2010;

Liu *et al.*, 2014; Miloud, 2014) and management buyouts (DeAngelo, 1986; Perry and Williams, 1994).

In the M&A setting, it is expected that acquirers who engage in stock swaps have a particular incentive to manage earnings upwards before making a bid, to look more attractive to the target's shareholders and to improve their chance of successfully completing the bid (Erickson and Wang, 1999; Botsari and Meeks, 2008). The effect of earnings management on M&As was first empirically investigated by Erickson and Wang (1999). Using a sample of 55 US acquirers completing stock-for-stock mergers from 1985 till 1990, they found that stock-financed bidders manage earnings upwards in the quarter immediately preceding the announcement date of the stock swap acquisition. They also reported that cash acquirers do not reveal significant levels of abnormal accruals during the pre-merger periods. Louis (2004) also found that discretionary current accruals are positive and statistically significant for acquiring firms who engage in stock swaps especially in the quarter immediately preceding the deal's announcement. Using a sample of 609 mergers of publicly traded targets and 898 mergers of privately held targets between 1990 and 1998, Baik *et al.* (2007) provided additional evidence that US acquirers are more likely to manage accrual-based earnings upwards when they use stock to acquire a privately held target. They argued that bidders have greater incentives to manage earnings before their acquisition if the respective target was privately held to compensate for the relatively higher level of information asymmetry.

Consistent with previous US studies, Botsari and Meeks (2008) found significant evidence of pre-merger earnings management for bidders who engage in stock-financed bids in the UK. The study covered a sample of 42 UK publicly traded acquiring firms, over the period 1997-2001, that used their shares in the deal's payment structure offered to the respective target firms. They documented strong evidence suggesting that acquiring firms engage in income-increasing accrual manipulation in the year immediately preceding the bid announcement.

In other regions, mixed results are found. For example, Koumanakos *et al.* (2005) examined a sample of 42 acquiring firms that successfully completed their bids in Greece during the period 2001-2003 and found positive, albeit weak, evidence of accounting earnings manipulation in the year prior to the announcement and the completion of the bid. Ardekani *et al.* (2012) found, in a sample of Malaysian firms during 2004-2010, evidence of upward earnings manipulation for stock acquirers but not for cash acquirers. Higgins (2013), using a sample of 133 Japanese stock-for-stock acquirers during 1990-2004, documented evidence that acquiring firms manage earnings upwards in the year preceding the bid announcement. Limited evidence also exists, in Australian M&As during the period 1986-1991, that the target company engages in earnings manipulation following the bid announcement (Edey and Taylor, 1999). Ben-Amar and Missonier-Piera (2008), on the other hand, found that managers of friendly takeover targets in Switzerland manage earnings downwards in the year prior to the event. Jeong and Bae (2013), in the Korean context, also found evidence of acquiring firms managing pre-merger earnings downwards, when the stock-for-stock merger is between firms in the same business group.

Given the motivation of the acquirers to manage earnings upwards before M&A deals and the supported empirical literature, we begin by replicating prior results in our sample and examine the following hypothesis:

H1a. Successful stock bidders engage in positive accrual-based earnings management in the accounting year prior to a bid announcement.

Several studies (Travlos, 1987; Loughran and Vijh, 1997; Linn and Switzer, 2001; Sudarsanam and Mahate, 2003; Moeller *et al.*, 2004; Dong *et al.*, 2006; and others) found that

acquirers experience negative stock returns around the announcement of stock-financed acquisitions but not cash-financed acquisitions. This could indicate that the announcement of cash acquisitions reveals more favourable information than the announcement of stock acquisitions, and hence, there is less incentives for cash bidders than stock ones to manage earnings. Also, from the accounting perspective of window dressing, it could be argued that acquirers who engage in stock swaps have more incentives than cash acquirers to manage their earnings upwards before the merger takes place to look more attractive to the target's shareholders and receive their approval. In this regard, the motivation of cash acquirers to manage earnings is limited because it will be a costly process that carries no economic return. Moreover, acquirer's shareholders retain the same level of control over their company in using cash versus stock as a mode of payment. Hence, there is no dilution of management control associated with cash acquisitions and any attempt to manage accrual- and/or real-based earnings should have no effect on the purchase deal. Therefore, we expect the following regarding earnings management practices in stock bidders when compared to cash bidders:

- H1b.* Successful stock bidders engage in more positive accrual-based earnings management in the accounting year prior to a bid announcement compared to cash bidders.

2.2 Real-based earnings management

Although most of the research in earnings management has focused on accrual-based earnings management, recent literature investigates the use of real activities in manipulating earnings. A US-based survey of top executives found that managers prefer real earnings management activities to manipulation of accruals (Graham *et al.*, 2005). They provide strong evidence that managers engage in real economic actions, which include price discounts to temporarily increase sales, excessive inventory production to lower the cost of goods sold and aggressive reduction in discretionary expenditures such as research and development (R&D) expenses to improve profit margins (Graham *et al.*, 2005). Prior research examined one particular real account manipulation method, such as the reduction of R&D expenditures (Baber *et al.*, 1991; Bushee, 1998), while others examined all three manipulation methods around a threshold, such as zero earnings (Roychowdhury, 2006).

Cohen and Zarowin (2010) examined both accrual- and real-based earnings management behaviour around SEOs for a sample of 1,511 completed US offers from 1987 to 2006. They found that US firms engage in income-increasing accrual manipulation, as well as real-based earnings management activities around SEOs, and that managers trade-off these two activities. Ibrahim *et al.* (2011) examined a sample of 1,871 SEO firms between 1990 and 2004 and found that SEO firms engage in income-increasing accrual and real account manipulation in the year prior to the offering. Zang (2012) investigated whether managers make accrual and real earnings manipulation simultaneously or sequentially. The author provided empirical evidence that accrual and real earnings management practices are implemented sequentially, with real earnings manipulation decisions preceding earnings management via accruals (Zang, 2012). Dionysiou (2015) examined both accrual and real accounts manipulation in a sample of UK pure placements (where pre-emptive rights of existing shareholders in secondary equity offerings are waived) and did not find evidence of either. In the M&A setting, only limited research examined the use of real manipulation around mergers. For example, Zhang (2015) found, in a sample of Chinese acquisitions during the period 2008-2010, that acquirers using stock-for-stock exchanges exhibit

significant negative abnormal cash flows and discretionary expenses prior to the merger, which provides evidence of upward real earnings manipulation.

Building on the empirical evidence of the existence of real earnings management activities to manage earnings, the following hypotheses are proposed:

- H2a.* Successful stock bidders engage in positive real-based earnings management in the accounting year prior to a bid announcement.
- H2b.* Successful stock bidders engage in more positive real-based earnings management in the accounting year prior to a bid announcement compared to cash bidders.

2.3 Higgs Report (2003) and earnings management

Given that accounting research should be closely tied to practice, prior research found that a significant area of research impact in different settings is regulatory policy (Benson *et al.*, 2014). Therefore, it is important to examine how regulation might impact the behaviour of firms around M&As. In the context of earnings manipulation, a growing consideration in the literature has been given to the important role of different corporate governance mechanisms and practices in monitoring managers' discretion and in limiting their abilities to manipulate earnings (Dechow *et al.*, 1996; Peasnell *et al.*, 2000a, 2000b; Xie *et al.*, 2003; Davidson *et al.*, 2005; Peasnell *et al.*, 2005; Habbash *et al.*, 2013a). For example, in the USA, regulatory changes through SOX in 2002 which strengthened governance mechanisms have led to a reduction in accrual earnings management in different contexts (Cohen *et al.*, 2008; Li *et al.*, 2008; Chen and Huang, 2013). Ewert and Wagenhofer (2005) showed analytically that earnings quality increases with tighter standards. However, managers increase costly real-based manipulation.

Recent governance reforms in Australia, through the "Corporate Governance Principles and Recommendations" (ASX, 2003, 2007, 2014), targeted areas that would improve monitoring, such as establishing a corporate governance committee. Evidence points to those reforms being associated with reduced earnings management (Liu, 2012). Moreover, based on 70 New Zealand listed companies over the period of 2000-2007, Bhuiyan *et al.* (2013) provided evidence that better compliance with corporate governance mechanisms is related to lower managerial discretionary accruals. Other research examined how particular governance attributes affect earnings management. For example, Davidson *et al.* (2005) found, in a sample of Australian firms in 2000, that a majority of non-executive directors on the board and on the audit committee are associated with a lower likelihood of earnings management. Moreover, through an Australian study of listed companies, Baxter and Cotter (2009) found that audit committees are associated with lower intentional earnings management activities. Chen *et al.* (2007) found that corporate governance characteristics (independence of supervisors, financial expertise of independent directors and voluntary formation of independent directorships) reduce the likelihood of earnings management for companies listed in Taiwan. This relation was stronger after the enactment of the corporate governance best-practice principles (CGBPP) in Taiwan. Similarly, Kasipillai and Mahenthiran (2013), through a sample of 221 Malaysian public listed companies from 2005 to 2008, found that corporate governance mechanisms (ownership structure and board structure) reduce earnings management activities.

Recent UK studies by Iqbal and Strong (2010) and Habbash *et al.* (2013a, 2013b) shed light on the crucial role and impact of the recent corporate governance recommendations and reforms on enhancing the reporting quality in the UK in general and constraining earnings management activities in particular. The Higgs Report on the Corporate

Governance Code (2003) stresses the importance of corporate governance mechanisms in enhancing the quality of accounting information. In addition to its recommendations that at least half of the board members should be independent non-executive directors, the [Higgs \(2003\)](#) Report stresses that one of the responsibilities of non-executive directors is to assure themselves about the integrity of financial information through enforcing financial control mechanisms and systems of risk management. In this regard, recent UK studies supported these recommendations by stressing the important role of non-executive directors in reducing earnings management activities ([Iqbal and Strong, 2010](#); [Habbash et al., 2013a](#)).

To the extent that the [Higgs \(2003\)](#) Report has had a major role in strengthening the Corporate Governance Code in UK, it is of interest to investigate the prevalence of both accrual- and real-based earnings management activities in the period leading to and following the implementation of Higgs recommendations. In this regard, the primary objective in examining changes in firms' earnings management practices is to investigate whether the passage of the report resulted in constraining such manipulation. We formulate the following hypotheses:

- H3a.* The magnitude of positive accrual-based earnings management by successful stock bidders is lower in the post-Higgs period than in the pre-Higgs one.
- H3b.* The magnitude of positive accrual-based earnings management by successful stock bidders compared to cash bidders is lower in the post-Higgs period than in the pre-Higgs one.

[Cohen et al. \(2008\)](#) found that the period prior to the passage of SOX in 2002 was characterized by higher levels of accrual-based earnings management activities and lower levels of real-based activities. On the other hand, they document that following the implementation of SOX, accrual-based earnings management practices decreased significantly, whereas real-based manipulation increased significantly. [Cohen et al. \(2008\)](#) and [Graham et al. \(2005\)](#) attributed this shift in earnings manipulation between accrual- and real-based activities before and after SOX to the crucial role of auditors or regulators in scrutinizing accrual manipulations rather than real ones after the passage of SOX.

In line with this, [Ibrahim et al. \(2011\)](#) found that the enactment of SOX has an impact in reducing accrual-based earnings management activities in the SEO setting. They stressed on the substitution effect between accrual- and real-based manipulations. [Zang \(2012\)](#) provided empirical evidence confirming that managers use these two forms of manipulation as substitutes. Based on this US evidence, we examine whether the level of real earnings management activities increased after Higgs and whether firms switched from accrual earnings management to real-based manipulation. The following hypotheses are formulated:

- H4a.* The magnitude of positive real-based earnings management by successful stock bidders is higher in the post-Higgs period than in the pre-Higgs one.
- H4b.* The magnitude of positive real-based earnings management by successful stock bidders compared to cash bidders is higher in the post-Higgs period than in the pre-Higgs one.

3. Sample and methodology

3.1 Data and sample selection

The sample in this study includes M&As announced by UK companies in the 20-year period from 1 January 1990 till 31 December 2009. The period is particularly interesting because in

the 1990s, the UK experienced the fourth M&A wave. Furthermore, during this period, there were major changes in the corporate governance arrangements, starting with the enforcement of the Cadbury Report in 1992 and the revision of the UK Corporate Governance Code introduced in July 2003 following the recommendations raised in the Higgs and Smith reports.

To be included in the final sample, each deal has to meet the following criteria:

- The deal was successfully completed between UK acquirers and domestic targets.
- Acquirers and targets must be publicly listed companies and traded on the London Stock Exchange for two reasons: The first reason is that both acquirers and targets are subject to same issuances of laws and regulations, such as the recommendations raised by the Higgs (2003) Report. The second reason is to minimize the differences in the level of information asymmetry between the bidder and the target.
- The deal is financed either by using pure cash or by offering shares to the target firm.[1]
- Acquirers and targets belong to an industry other than the banking and financial industry, as they are subject to specific accounting requirements which may differ substantially from other sectors.
- The acquirer has the necessary financial data on Datastream to estimate the annual proxies for both accrual- and real-based earnings management in the period prior to the announcement deal.

To account for confounding multiple transactions, we require that acquisitions by the same firm not be in adjacent fiscal periods. We first examine all acquisitions and determine the fiscal period in which they were announced. To limit misspecification of the accrual and real manipulation measures in the year prior to the announcement, if an acquirer has two acquisitions in adjacent years, we keep only the first acquisition.[2]

In addition to exclusion of observations owing to unavailable data, a few observations are deleted to mitigate the effects of outliers. The mean plus/minus 3 standard deviation rule is used to check the distribution of variables in the study, and we exclude extreme values.

The final sample consists of 197 firm observations of acquirers that meet the sampling criteria and have available data. Sample data for the M&As were drawn from two main sources, namely, Thomson One Banker and Datastream. The detailed sample selection procedure is illustrated in Table I. In the final sample, there are 23 firms with multiple acquisitions that span the sample period. Out of these, 21 firms have two acquisition deals that are not in adjacent years. The remaining two acquirers have three acquisition deals not in adjacent years.

Table II reports the distribution of the final sample comprising 197 bids. Panel A presents the distribution of the overall sample of acquirers by year for the full sample and by mode of payment. The sample distribution by year indicates that merger activities peaked at the end of the 1990s. From the entire sample, 75 bids are stock offers and the remaining are cash ones. Panel B of this table demonstrates how the sample is distributed across a total range of 12 industry sectors. These sectors are classified according to the Fama and French 12 industry classification using the two-digit SIC codes. Sectors that are more representative than others in the sample are as follows: manufacturing with 23 acquirers (11.68 per cent), healthcare with 19 acquirers (9.64 per cent), business equipment with 17 acquirers (8.63 per cent) and wholesale and retail with 16 acquirers (8.12 per cent). A comparison of cash and stock bids reveals differences across the healthcare industry (16 per cent of stock bids but only 5.74 per cent of cash bids) as well as the energy sector (4 per cent of stock bids but only 0.82 per cent of cash bids).

JAOC 13,4	Description	N
	Initial sample: public acquirer/target between 01/01/1990 to 31/12/2009	2,252
	<i>Exclude:</i>	
	Acquirer/Target from the financial sector	831
	Unsuccessful deals ^a	256
500	Deals whose method of payment are neither pure stock nor pure cash	492
	Share repurchases ^b	297
	Reverse takeovers ^c	15
	Missing Datastream codes	28
	Unavailable accounting and share price data in Datastream ^d	108
	Acquisition by same acquirer in adjacent years	28
	<i>Final sample</i>	197

Notes: ^aUnsuccessful bids include rumour, discontinued rumour and withdrawn deals; ^bdeals in which both the acquirer and the target are the same; ^caccording to Thomson Financial (TF) deal definitions, a reverse takeover indicates a merger in which the acquiring company offers more than 50% of its equity as consideration offered to the target company resulting in the target company becoming the majority owner of the new company. These deals are excluded because they could confound the results; ^din addition to the unavailable data, few observations for some control variables are deleted to mitigate the effects of outliers; the mean plus/minus 3 standard deviation rule is used to check the distribution of these variables and exclude extreme values

Table I.
Sample selection
procedures

There are 131 bids that took place before the enactment of the [Higgs \(2003\)](#) Report (classified as years 1990-2002), of which 42 are stock offers and the remaining are cash ones. The period after the issuance of this report reveals that out of 66 bids, 33 are stock offers and the rest are cash ones.

3.2 Accrual-based earnings management measures

Accrual-based earnings management is measured using both the discretionary current accruals and the discretionary total accruals based on the cross-sectional version of the modified Jones model ([Jones, 1991](#); [Dechow et al., 1995](#)), with modifications suggested by [Kothari et al. \(2005\)](#). We use current accruals, as [Botsari and Meeks \(2008\)](#) and [Louis \(2004\)](#) noted that in M&As and for valuing bidders and targets, investment bankers rely heavily on earnings before interest, taxes, depreciation and amortization (EBITDA). In this case, the bidder has greater incentives to manage current accruals. We also use total accruals for robustness, as this may indicate overinvestment activities and/or agency problems of the bidders; the difference between total accruals and current accruals comes from depreciation and amortization expense which is related to fixed assets and company size ([Dionysiou, 2015](#)). We use the cash flow approach in measuring current and total accruals, given that the balance sheet approach can distort accruals especially around non-articulation events such as M&As ([Hribar and Collins, 2002](#)).

We measure earnings management in the year preceding the takeover as identified by the announcement date of the deal, as provided in the Thomson One Banker database, assuming that acquirers manage earnings before the announcement of a bid ([DeFond and Park, 2001](#); [Dechow et al., 2012](#); [Higgins, 2013](#)). The acquisition year (year t) and pre-acquisition year (year $t-1$) are determined similar to [Iqbal et al. \(2009\)](#). As an example, if a firm has a 31 December year-end, we assume that accounting information for the financial year 2006 is available by 31 March 2007. If the firm announces an acquisition between

Year	Stock bids		Cash bids		All bids	
	Frequency	(%)	Frequency	(%)	Frequency	(%)
<i>Panel A: Distribution of sample acquirers by year</i>						
1990	1	1.33	5	4.10	6	3.05
1991	3	4.00	9	7.38	12	6.09
1992	1	1.33	9	7.38	10	5.08
1993	1	1.33	5	4.10	6	3.05
1994	3	4.00	7	5.74	10	5.08
1995	1	1.33	11	9.02	12	6.09
1996	4	5.33	6	4.92	10	5.08
1997	4	5.33	9	7.38	13	6.60
1998	5	6.67	7	5.74	12	6.09
1999	10	13.33	6	4.92	16	8.12
2000	3	4.00	7	5.74	10	5.08
2001	4	5.33	5	4.10	9	4.57
2002	2	2.67	3	2.46	5	2.54
2003	7	9.33	3	2.46	10	5.08
2004	4	5.33	3	2.46	7	3.55
2005	5	6.67	8	6.56	13	6.60
2006	3	4.00	6	4.92	9	4.57
2007	4	5.33	5	4.10	9	4.57
2008	3	4.00	2	1.64	5	2.54
2009	7	9.33	6	4.92	13	6.60
Total	75	100%	122	100%	197	100%
<i>Panel B: Distribution of sample acquirers by industry</i>						
Industry	Stock bids		Cash bids		All bids	
Consumer non-durables	5	6.67	2	1.64	7	3.55
Consumer durables	3	4.00	6	4.92	9	4.57
Manufacturing	8	10.67	15	12.30	23	11.68
Energy	3	4.00	1	0.82	4	2.03
Chemicals	1	1.33	3	2.46	4	2.03
Business equipment	7	9.33	10	8.20	17	8.63
Telecommunications	2	2.67	7	5.74	9	4.57
Utilities	2	2.67	5	4.10	7	3.55
Wholesale and retail	6	8.00	10	8.20	16	8.12
Healthcare	12	16.00	7	5.74	19	9.64
Finance	3	4.00	7	5.74	10	5.08
Other	23	30.67	49	40.16	72	36.55
Total	75	1	122	1	197	1

Table II.
Distribution of
sample acquirers by
year and industry

Note: Industries are based on Fama French 12 classification

1 April 2007 and 31 March 2008, we use accounting information for 2006 as the data for the pre-acquisition year.

Discretionary accruals are estimated in a two-step process. The first step involves the estimation of non-discretionary accruals based on the following cash flow approach of the current accrual model:

$$\frac{CAC_{ij,t}}{TA_{ij,t-1}} = \alpha_0 \left(\frac{1}{TA_{ij,t-1}} \right) + \alpha_1 \left(\frac{\Delta REV_{ij,t}}{TA_{ij,t-1}} \right) + \alpha_2 (ROA_{ij,t}) + \varepsilon_{ij,t}$$

where:

$CAC_{ij,t}$ = is the current accruals for a firm i in industry group j for year t , measured as net income before extraordinary items less operating cash flow less depreciation and amortization;

$\Delta REV_{ij,t}$ = is the change in revenues for firm i in industry group j for year t ;

$TA_{ij,t-1}$ = is total assets for firm i in industry group j for year $t-1$;

$ROA_{ij,t}$ = is return on assets for firm i in industry group j for year t ; and

$\varepsilon_{ij,t}$ = is the residual term for firm i in industry group j for year t .

All variables in the above regression model, other than $ROA_{ij,t}$, are scaled by lagged total assets ($TA_{ij,t-1}$) to reduce heteroskedasticity. The estimation of coefficients α_0 , α_1 and α_2 is done using all data from Datastream for all available firms and not only the sample M&A firms. The regressions are based on industry and year combination, with industry classification based on the Fama and French 12 industry classification. The full set of observations in Datastream is used to ensure unbiased estimates for the above coefficients.

The estimates of α_0 , α_1 and α_2 are used to calculate normal or non-discretionary current accruals ($NCAC_{ij,t}$). [3] Abnormal current accruals ($A_CA_{ij,t}$) are then estimated as the difference between current accruals and normal or non-discretionary accruals.

The following cross-sectional regression model is used to estimate the cash flow-based total discretionary accrual for each industry and year combination:

$$\frac{TAC_{ij,t}}{TA_{ij,t-1}} = a_0 \left(\frac{1}{TA_{ij,t-1}} \right) + a_1 \left(\frac{\Delta REV_{ij,t}}{TA_{ij,t-1}} \right) + a_2 \left(\frac{PPE_{ij,t}}{TA_{ij,t-1}} \right) + a_3 (ROA_{ij,t}) + \varepsilon_{ij,t}$$

where:

$TAC_{ij,t}$ = is total accruals for firm i in industry group j for year t , measured as net income before extraordinary items less operating cash flow; and

$PPE_{ij,t}$ = is the gross property plant and equipment for firm i in industry group j for year t .

All other variables are as previously defined.

We use ordinary least squares (OLS) regressions to estimate the above coefficients by each industry group and year to calculate normal or non-discretionary total accruals ($NTAC_{ij,t}$). Then, the abnormal total accruals ($A_TA_{ij,t}$) represent the difference between the total accruals and the non-discretionary or normal accruals.

3.3 Real-based earning management measures

According to prior US studies by Roychowdhury (2006), Cohen and Zarowin (2010), Ibrahim et al. (2011) and Zang (2012), real earnings management activities can be undertaken by the following three methods:

- (1) Sales manipulation by accelerating the timing of sales through increasing price discounts or offering more lenient credit terms that will in turn temporarily increase sales levels.
- (2) Discretionary expenditures manipulation by reducing advertising expenses, R&D expenses and selling, general and administrative (SG&A) expenses. The reduction in these discretionary expenditures will boost current period earnings, especially if they do not generate immediate revenues and income.
- (3) Production manipulation by overproducing goods to meet expected demand and boost earnings.

Based on these manipulation methods, three proxies are derived to measure real earnings management activities: abnormal cash from operations (A_CFO), abnormal discretionary expenses (A_DISX) and abnormal production costs (A_PROD). To estimate the abnormal values of these proxies, the normal levels of cash from operations, discretionary expenses and production costs are calculated by implementing the models developed by [Dechow et al. \(1998\)](#) and as followed in [Roychowdhury \(2006\)](#). Following [Dechow et al. \(1998\)](#), normal cash flow from operations are expressed as follows:

$$\frac{CFO_{ij,t}}{TA_{ij,t-1}} = a_0 \frac{1}{TA_{ij,t-1}} + a_1 \frac{REV_{ij,t}}{TA_{ij,t-1}} + a_2 \frac{\Delta REV_{ij,t}}{TA_{ij,t-1}} + \varepsilon_{ij,t}$$

where:

$CFO_{ij,t}$ = is operating cash flow for firm i in industry group j for year t .

All other variables are as previously defined.

The estimation of coefficients a_0 , a_1 and a_2 for each industry group is done in each year by following OLS regressions using the full data available in Datastream, and these are used to calculate the normal level of CFO. Abnormal CFO (A_CFO) is the difference between actual CFO and the normal level of CFO.

Production costs are defined as the sum of cost of goods sold (COGS) and change in inventory during the year. Following [Dechow et al. \(1998\)](#), we estimate the normal level of production costs through the following industry-year regressions:

$$\frac{PROD_{ij,t}}{TA_{ij,t-1}} = a_0 \frac{1}{TA_{ij,t-1}} + a_1 \frac{REV_{ij,t}}{TA_{ij,t-1}} + a_2 \frac{\Delta REV_{ij,t}}{TA_{ij,t-1}} + a_3 \frac{\Delta REV_{ij,t-1}}{TA_{ij,t-1}} + \varepsilon_{ij,t}$$

where:

$PROD_{ij,t}$ = is the sum of the cost of goods sold and inventory change for firm i in industry j and year t .

All other variables are as previously defined.

Abnormal production costs (A_PROD) are computed as the difference between the actual value of the production costs and its normal level predicted from the estimated coefficients of the regression model.

Similarly, following [Roychowdhury \(2006\)](#), normal discretionary expenses are measured through the following regression:

$$\frac{DISX_{ij,t}}{TA_{ij,t-1}} = a_0 \frac{1}{TA_{ij,t-1}} + a_1 \frac{REV_{ij,t-1}}{TA_{ij,t-1}} + \varepsilon_{ij,t}$$

where:

$DISX_{ij,t}$ = is discretionary expenses for firm i in industry group j for year t .

All other variables are as previously defined.

Abnormal discretionary expenses (A_DISX) represent the difference between the discretionary expenses and their value at its normal level as predicted from the estimated coefficients of the regression model. Discretionary expenses are defined as the sum of R&D expenses and SG&A expenses. In calculating discretionary expenses, if SG&A is not missing but the R&D value is missing, then R&D is set to zero.

For a given level of sales, an upward manipulation in real-based earnings is detected, if firms have unusually low cash flow from operations (i.e. negative abnormal CFO) and/or unusually low discretionary expenditures (i.e. negative abnormal discretionary expenses) and/or unusually high production costs (i.e. positive abnormal production costs).

Table III presents correlation coefficients between all above accrual and real manipulation measures. As can be seen, *A_CA* and *A_TA* are highly correlated (coefficient = 0.893; significant at the 1 per cent level). The highest correlation between accrual- and real-based manipulation measures is between *A_CA* and *A_CFO* (coefficient = -0.521; significant at the 1 per cent level). As can be seen, there is a negative correlation between both accrual manipulation measures and *A_CFO* as well as *A_DISX*, given that the first has an income-increasing effect, whereas the latter two have an income-decreasing effect. Furthermore, there is a positive correlation between both accrual manipulation measures and *A_PROD*, as both indicate income-increasing behaviour.

4. Empirical results

4.1 Accrual-based earnings management prior to merger announcements

Table IV presents the mean and median values for both current and total accruals in the overall sample and for stock and cash bidders, separately. The mean abnormal working capital accruals of 0.019 and the median estimate of 0.018 in Table IV are both statistically different from zero for the entire sample. When the sample is divided into stock and cash bids, different results between these two groups are observed. The mean and median abnormal current accrual for bidders engaging in stock swaps are 0.031 (significant at the 10

Table III.
Pearson correlation coefficients (*p*-values) between accrual-based and real-based earnings management proxies

Variable	A_TA	A_CFO	A_DISX	A_PROD
A_CA	0.893 (0.000)	-0.521 (0.000)	-0.166 (0.036)	0.067 (0.376)
A_TA		-0.596 (0.000)	-0.115 (0.149)	-0.028 (0.715)
A_CFO			0.069 (0.388)	-0.146 (0.051)
A_DISX				-0.340 (0.000)

Notes: *A_CA* = discretionary current accruals measured using modified Jones model with Kothari *et al.* (2005) modifications; *A_TA* = discretionary total accruals measured using modified Jones model with Kothari *et al.* (2005) modifications; *A_CFO* = abnormal cash flow from operations; *A_DISX* = abnormal discretionary expenses; *A_PROD* = abnormal production costs

Table IV.
Accrual-based earnings management proxies derived from the cross-sectional modified Jones model based on the cash flow approach

Variable	All bids		Stock bids		Cash bids		Difference Stock - Cash	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
<i>A_CA</i>	<i>0.019**</i>	<i>0.018**</i>	<i>0.031*</i>	<i>0.039***</i>	0.012	0.000	0.019	<i>0.039**</i>
<i>p</i> -Value	(0.046)	(0.043)	(0.061)	(0.008)	(0.193)	(0.366)	(0.210)	(0.038)
No. of obs.	197		75		122			
<i>A_TA</i>	0.005	-0.003	0.014	<i>0.024*</i>	0.000	-0.007	0.014	<i>0.031**</i>
<i>p</i> -Value	(0.274)	(0.458)	(0.182)	(0.068)	(0.489)	(0.112)	(0.237)	(0.046)
No. of obs.	193		73		120			

Notes: This table presents accrual-based earnings management measures for the acquirers in the year prior to the deal's announcement date. The results are based on parametric (*t*-tests for the means) and non-parametric (Wilcoxon signed-rank test for the medians) tests. *p*-Values are given in parentheses and significant results are marked in italics; ***, ** and * denote one-tailed significance at 1, 5 and 10% level, respectively; *A_CA* = discretionary current accruals measured using modified Jones model with Kothari *et al.* (2005) modifications; *A_TA* = discretionary total accruals measured using modified Jones model with Kothari *et al.* (2005) modifications

per cent level) and 0.039 (significant at the 1 per cent level), respectively. These results support the first proposed hypothesis (*H1a*) in this study and are consistent with [Louis \(2004\)](#) and [Botsari and Meeks \(2008\)](#). For instance, [Botsari and Meeks \(2008\)](#) found that the median discretionary accrual is 0.03 and statistically significant at the 5 per cent level. Under the total accrual measure, discretionary accruals for stock bids are again positive but are not statistically significant, except for the median.

When comparing stock and cash bids, we find that the median differences (using the Wilcoxon rank sum test) for current and total abnormal accruals are 0.039 and 0.031 (both significant at the 5 per cent level), respectively. This indicates that the stock-financed acquirers have significantly higher abnormal accruals than the cash-financed acquirers, in support of *H1b*. These findings are consistent with those reported by [Erickson and Wang \(1999\)](#), [Louis \(2004\)](#) and [Botsari and Meeks \(2008\)](#), who found that stock bidders have significantly higher abnormal accruals than cash ones.

4.2 Real-based earnings management prior to merger announcements

Results in [Table V](#) provide the mean and median estimates of the three measures *A_CFO*, *A_DISX* and *A_PROD* in the year preceding the announcement date for the entire sample and for cash and stock bids, separately. As discussed in the previous section, a negative *A_CFO* and *A_DISX* and a positive *A_PROD* all indicate positive earnings manipulation. The mean and median values for the three real-based earnings management proxies for stock acquirers are not significant (except for *A_CFO*, which has a significant positive median) and thus do not support *H2a*. Therefore, the findings do not support the view that stock bidders manage, in addition to accrual-based earnings, real-based ones. One reason for this could be that real activities manipulation is more costly than accrual manipulation and therefore would be less preferred by managers ([Zang, 2012](#); [Abernathy et al., 2014](#)).

The median values of *A_CFO* for the whole sample and for cash-paying acquirers are positive and statistically significant at the 1 per cent level, which is not consistent with income-increasing real account manipulation. However, the negative mean and median

Variable	All bids		Stock bids		Cash bids		Difference Stock – Cash	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
<i>A_CFO</i>	0.011	<i>0.015***</i>	0.015	<i>0.003*</i>	0.008	<i>0.016***</i>	0.006	-0.013
<i>p</i> -Value	(0.284)	(0.002)	(0.223)	(0.084)	(0.384)	(0.001)	(0.426)	(0.156)
No. of obs.	197		75		122			
<i>A_DISX</i>	<i>-0.039**</i>	<i>-0.058***</i>	0.051	-0.022	<i>-0.091***</i>	<i>-0.106***</i>	<i>0.142***</i>	<i>0.084***</i>
<i>p</i> -Value	(0.027)	(0.001)	(0.103)	(0.153)	(0.000)	(0.000)	(0.001)	(0.001)
No. of obs.	160		59		101			
<i>A_PROD</i>	0.013	<i>0.025**</i>	-0.020	0.011	<i>0.031**</i>	<i>0.030**</i>	<i>-0.051*</i>	-0.019
<i>p</i> -Value	(0.194)	(0.042)	(0.243)	(0.233)	(0.045)	(0.022)	(0.068)	(0.139)
No. of obs.	179		61		118			

Notes: This table presents real-based earnings management measures for the acquirers in the year prior to the deal's announcement date. The results are based on parametric (*t*-tests for the means) and non-parametric (Wilcoxon signed-rank test for the medians) tests. *p*-Values are given in parentheses and significant results are marked in italics; ***, ** and * denote one-tailed significance at 1, 5 and 10% level, respectively; *A_CFO* = abnormal cash flow from operations; *A_DISX* = abnormal discretionary expenses; *A_PROD* = abnormal production costs

Table V.
Real-based earnings
management proxies

estimates for the abnormal discretionary expenses of -0.091 and -0.106 , respectively (both significant at the 1 per cent level), for cash bidders indicate that they reduce these expenses substantially. This significant reduction in discretionary expenditures increases cash flows from operations and hence may lead to positive estimates of A_CFO .

When comparing stock bidders to cash bidders, we find that stock acquirers have significantly lower income-increasing manipulation through A_DISX than the cash acquirers for both the mean and median (cash acquirers have more negative abnormal discretionary expenses), and this is statistically significant at the 1 per cent level. The statistically significant mean difference for A_PROD of -0.051 between stock and cash bids also indicates that stock bidders engage less in real-based earnings management activities through overproduction than cash bidders (cash acquirers have more positive abnormal production). Therefore, we do not find support for $H2b$.

The lack of support for this hypothesis could be associated with the costs and constraints faced by firms in using real-based earnings management. Lower industry market share, poorer financial condition and higher tax rates are important constraints in managing earnings through real-based activities (Zang, 2012; Abernathy *et al.*, 2014).

4.3 Accrual-based earnings management prior to merger announcements: pre- versus post-Higgs
The Higgs (2003) Report plays a major role in improving corporate governance through, among other things, calling for greater representation of outside directors on UK corporate boards. Table VI presents the acquirers' mean and median current and total abnormal accruals pre- and post-Higgs after separating the sample into stock and cash acquirers. The mean (median) current and total abnormal accruals for stock bidders in the pre-Higgs period show statistically significant positive estimates of 0.022 (0.031) and 0.023 (0.029), respectively. However, the results for the difference in the mean and median figures for abnormal current accruals between pre- and post-Higgs groups are not statistically significant and do not support $H3a$. Therefore, it does not appear that stock acquirers have reduced accrual manipulation following the enactment of the Higgs recommendations. This could be owing to the fact that when managers find that certain earnings management strategies (real-based ones) are more costly and constrained than the others, they will concentrate on other earnings management strategies (such as accrual-based ones) with less constraints and costs (Zang, 2012). This is feasible, especially given the low litigation risk in the UK compared to other countries, such as the USA (Seetharaman *et al.*, 2002). Therefore, it appears that the recommendations set out in the Higgs Report have not mitigated accrual earnings management.

The analysis of the cash acquirers subsample for the current and total abnormal accrual fails to yield any statistical significant results either for the pre-Higgs or for the post-Higgs sample.

In comparing the difference between stock and cash bidders in the pre-Higgs and post-Higgs periods, we find that stock bidders have statistically significant higher income-increasing accruals only in the pre-Higgs period. Specifically, the median difference for A_CA (A_TA) is 0.033 (0.036), significant at the 10 (5 per cent) level. This partially supports $H3b$.

To sum up, this analysis indicates that the overall level of accrual-based earnings management activities for stock acquirers is not significantly lower in the post-Higgs era. These findings are not consistent with findings in other contexts, such as Cohen *et al.* (2008) and Ibrahim *et al.* (2011), who found a decrease in the accrual-based earnings manipulation after the passage of SOX in 2002, and Chen *et al.* (2007), who also found a greater reduction in earnings management after the enactment of the CGBPP in Taiwan. However, when comparing stock and cash bidders, there is evidence of higher manipulation using accruals before the enactment of the Higgs recommendations but not after.

Variable	Pre-Higgs bids		Stock bids		Difference pre-post		Cash bids		Difference between stock and cash bids	
	Mean	Median	Post-Higgs bids	Pre-Higgs bids	Mean	Median	Pre-Higgs bids	Post-Higgs bids	Pre-Higgs bids	Post-Higgs bids
A_CA	0.022*	0.031***	0.043	0.063*	-0.022	-0.032	0.010	-0.003	0.012	0.033*
p-Value	(0.095)	(0.041)	(0.148)	(0.097)	(0.297)	(0.197)	(0.288)	(0.485)	(0.306)	(0.071)
No. of obs.	42		33				89	33		
A_TA	0.0223**	0.029**	0.002	0.024	0.021	0.005	0.000	-0.007	0.023	0.036**
p-Value	(0.049)	(0.045)	(0.473)	(0.442)	(0.264)	(0.266)	(0.498)	(0.123)	(0.120)	(0.017)
No. of obs.	41		32				87	33		

Notes: This table presents accrual-based earnings management measures for the acquirers in the year prior to the deal's announcement date. The results are based on parametric (*t*-tests for the means) and non-parametric (Wilcoxon signed-rank test for the medians) tests. *p*-Values are given in parentheses and significant results are marked in italics; ** and * denote one-tailed significance at 5 and 10% level, respectively. *A_CA* = discretionary current accruals measured using modified Jones model with [Kothari et al. \(2005\)](#) modifications; *A_TA* = discretionary total accruals measured using modified Jones model with [Kothari et al. \(2005\)](#) modifications

Table VI.
Accrual-based
earnings
management proxies
derived from the
cross-sectional
modified Jones model
based on the cash
flow approach for the
pre- and post-Higgs
bids with the method
of payment

4.4 Real-based earnings management prior to merger announcements: pre- versus post-Higgs

The effect of the enactment of the Higgs (2003) Report on real earnings management proxies is also tested to examine if there is any change in earnings manipulation between the two periods. As shown in Table VII, the mean and median A_CFO , A_DISX and A_PROD for stock bidders in the pre- and post-Higgs periods do not reveal significant figures. Moreover, the mean and median differences between the two periods do not exhibit statistically significant results; therefore, there is no support for $H4a$.

Results in Table VII also provide some evidence of a difference in income-increasing manipulation through real accounts for cash bidders between pre- and post-Higgs periods. The mean (median) estimates of A_DISX for cash bidders are -0.165 (-0.142) in the post-Higgs period as compared to -0.061 (-0.086) in the pre-Higgs period.

When comparing stock versus cash bidders in both periods, we find significant differences in A_DISX both before and after the enactment of Higgs [mean (median) differences are 0.114 (0.059) before Higgs and 0.212 (0.156) after Higgs, significant at 10 per cent level or below]. Therefore, there is no support for $H4b$.

Therefore, unlike US evidence of a shift to real earnings manipulation after the passage of SOX 2002, UK cash bidders engage in real-based earnings management activities through reducing discretionary expenses before the enactment of the Higgs Report and enhance them in the post-Higgs era. This insignificant evidence of substituting accrual-based with real-based earnings management activities could be owing to the higher costs and constraints for real-based manipulation as compared to engaging in accrual-based activities (Zang, 2012).

4.5 Multivariate analysis

To further examine the use of accrual and real manipulation in acquisitions that are financed by stock compared to those financed by cash, we provide multivariate results while controlling for variables related to the acquirer itself as well as variables related to the bid. The following logistic regressions are used:[4]

$$\begin{aligned}
 STK = & a_0 + a_1A_CA(A_TA) + a_2A_CFO + a_3A_DISX + \alpha_4A_PROD + \alpha_5PREM \\
 & + \alpha_6INDR + a_7SIZE + a_8LEV + a_9MTBV + \alpha_{10}OWN \\
 & + \sum \alpha_jIND + \sum \alpha_lyear + \varepsilon
 \end{aligned} \tag{1}$$

$$\begin{aligned}
 STK = & a_0 + a_1A_CA(A_TA) + a_2A_CFO + a_3A_DISX + \alpha_4A_PROD + \alpha_5POST \\
 & - HIGGS + \alpha_6A_CA(A_TA)*POST - HIGGS + \alpha_7A_CFO*POST - HIGGS \\
 & + \alpha_8A_DISX*POST - HIGGS + \alpha_9A_PROD*POST - HIGGS + \alpha_{10}PREM \\
 & + \alpha_{11}INDR + a_{12}SIZE + a_{13}LEV + a_{14}MTBV + \alpha_{15}OWN \\
 & + \sum \alpha_jIND + \sum \alpha_lyear + \varepsilon
 \end{aligned} \tag{2}$$

where:

STK = is a dummy variable taking the value of 1 if the acquisition was financed by stock and 0 if financed by cash;

$POST_HIGGS$ = is a dummy variable taking the value of 1 if the acquisition was in the post-Higgs time period and 0 otherwise;

$PREM$ = is the percentage premium paid by the acquirer with respect to the target's share price four weeks prior to the announcement date as provided by Thomson One Banker;

Variable	Pre-Higgs bids		Stock bids		Difference pre-post		Cash bids		Pre-Higgs bids		Post-Higgs bids		Difference between stock and cash bids	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median
<i>A_CFO</i>	0.004 (0.402)	-0.015 (0.464)	0.029 (0.234)	0.017 (0.128)	-0.032 (0.126)	-0.024 (0.285)	0.009** (0.023)	0.087*** (0.002)	0.025 (0.272)	-0.024 (0.142)	-0.058 (0.115)	-0.048 (0.170)		
No. of obs.	42		33		89		33							
<i>A_DISX</i>	0.053 (0.132)	-0.027 (0.476)	0.048 (0.260)	0.014 (0.288)	-0.041 (0.414)	0.005 (0.477)	-0.086*** (0.001)	-0.165*** (0.001)	0.114** (0.014)	0.059** (0.037)	0.212** (0.010)	0.156*** (0.004)		
No. of obs.	36		23		72		29							
<i>A_PROD</i>	-0.002 (0.473)	0.002 (0.348)	-0.049 (0.214)	0.018 (0.445)	-0.016 (0.462)	0.047 (0.243)	0.017 (0.088)	0.049 (0.121)	-0.026 (0.220)	-0.015 (0.265)	-0.097* (0.094)	-0.067 (0.171)		
No. of obs.	37		24		87		31							

Notes: This table presents real-based earnings management measures for the acquirers in the year prior to the deal's announcement date. The results are based on parametric (*t*-tests for the means) and non-parametric (Wilcoxon signed-rank test for the medians) tests. *p*-Values are given in parentheses and significant results are marked in italics; ***, ** and * denote one-tailed significance at 1, 5 and 10% level, respectively; *A_CFO* = abnormal cash flow from operations, *A_DISX* = abnormal discretionary expenses, *A_PROD* = abnormal production costs

Table VII.
Real-based earnings
management proxies
for the pre- and post-
Higgs bids with the
method of payment

- INDR* = is a dummy variable for industry relatedness of the merging firms which takes the value of 1 if the acquirer and target have the same two-digit SIC codes;
- SIZE* = is the size of the acquirer as measured by the log of its total assets, from Datastream;
- LEV* = is leverage as measured by the acquirer's total debt divided by total assets, both from Datastream.
- MTBV* = is the market-to-book value of the acquirer defined as the market value of the common equity divided by the book value of the common equity the year before the merger announcement, both from Datastream; and
- OWN* = is the total percentage of shares held by outsiders holding 5 per cent or more of total shares, from company's annual report.

All other variables are as previously defined.

We include all accrual and real manipulation variables in the regression to test the significance of each. Therefore, our coefficients of interest are α_1 - α_4 in regression (1). To test for any differences across the periods before and after Higgs, we add interaction variables in regression (2) and therefore our coefficients of interest are α_1 - α_4 as well as α_6 - α_9 . We do not include both *A_CA* and *A_TA* in the same regression, as they are highly correlated and both represent accrual manipulation, but we run regressions using each separately. We include as control variables the four-week premium, as prior research shows a significant relationship between the payment method and the payment of premium (Antoniou *et al.*, 2008). We also include the industry-relatedness of the acquirer and target, as empirical evidence suggests that there is a difference in the impact of the bid on shareholder wealth for acquirers who engage in related acquisitions as compared to those in unrelated transactions (Matusaka, 1993; Archbold, 2000; Walker, 2000). We also include the size of the acquirer and the leverage, as these variables can affect the performance of the acquirer firm (Dickerson *et al.*, 1997). We include the market-to-book value of the acquirer to control for the growth prospects, especially that the empirical evidence reports that value firms (low *MTBV*) experience larger gains than glamour ones (high *MTBV*) (Sudarsanam and Mahate, 2003) and cash acquirers are less overvalued than stock ones (Dong *et al.*, 2006). We also include *OWN*, which controls for governance characteristics. Higher outside ownership of shares may indicate more scrutiny and lower opportunities of manipulation. This variable has been previously used to control for the governance structure in the earnings management context (Kasipillai and Mahenthiran, 2013). Finally, we include year and industry dummies. The results are presented in Tables VIII and IX.

Table VIII presents results of the regressions using *A_CA* as the accrual manipulation variable. Unlike the univariate results, there is no evidence that stock-financed bids have a higher prevalence of accrual manipulation than cash-financed bids in the full sample (coefficient of *A_CA* is not significant). However, the results in the first column indicate that bids that are financed by cash have significantly less abnormal discretionary expenses (coefficient = 5.961; significant at the 5 per cent level). This finding corroborates the result using mean differences for *A_DISX*. Therefore, cash bidders appear to reduce their discretionary expenses in preparation for an acquisition, which would indicate income-increasing manipulation.

The results including the *POST-HIGGS* indicator variable as well as the interaction terms reveal some significant differences between the pre- and post-Higgs periods. Specifically, the coefficient for *A_DISX* and *A_PROD* are both positive and significant (coefficient = 12.5 and 11.5 for *A_DISX* and *A_PROD*, respectively, both significant at the 5 per cent level). Whereas *A_CFO* and *A_PROD* are significantly lower across the post-Higgs period (coefficient = -21.7 and -19.2 for *A_CFO* \times *POST-HIGGS* and *A_PROD* \times *POST-HIGGS*, respectively, both

Variable	Coefficient	<i>p</i> -value	Coefficient	<i>p</i> -value
Intercept	6.342*	0.068	16.481**	0.014
A_CA	3.231	0.207	-3.135	0.375
A_CFO	1.367	0.185	3.248	0.214
A_DISX	5.961**	0.016	12.510*	0.050
A_PROD	-2.115	0.229	11.545*	0.085
POST-HIGGS			-6.753	0.127
A_CA × POST-HIGGS			16.341	0.101
A_CFO × POST-HIGGS			-21.665**	0.013
A_DISX × POST-HIGGS			1.732	0.420
A_PROD × POST-HIGGS			-19.154**	0.038
PREM	-0.006	0.347	-0.063**	0.026
INDR	0.301	0.375	2.248*	0.087
SIZE	-0.857*	0.097	-1.057	0.104
LEV	-4.582	0.118	-7.192	0.101
MTBV	-0.087	0.201	-0.296**	0.043
OWN	-0.027	0.135	0.020	0.340
Industry dummies	YES		YES	
Year Dummies	YES		YES	
<i>N</i>	107		107	
Likelihood ratio	68.236		84.957	
<i>p</i> -Value	0.003		0.001	

Notes: The following table presents coefficients and *p*-values from logistic regressions of the form:

$$STK = a_0 + a_1A_CA + a_2A_CFO + a_3A_DISX + \alpha_4A_PROD + \alpha_5PREM + \alpha_6INDR$$

$$+ a_7SIZE + a_8LEV + a_9MTBV + \alpha_{10}OWN + \sum \alpha_jIND + \sum \alpha_iyear + \varepsilon$$

$$STK = a_0 + a_1A_CA + a_2A_CFO + a_3A_DISX + \alpha_4A_PROD + \alpha_5POST - HIGGS$$

$$+ \alpha_6A_CA(A_TA)*POST - HIGGS + \alpha_7A_CFO*POST - HIGGS$$

$$+ \alpha_8A_DISX*POST - HIGGS + \alpha_9A_PROD*POST - HIGGS + \alpha_{10}PREM$$

$$+ \alpha_{11}INDR + a_{12}SIZE + a_{13}LEV + a_{14}MTBV + \alpha_{15}OWN$$

$$+ \sum \alpha_jIND + \sum \alpha_iyear + \varepsilon$$

Table VIII.
Multivariate analysis
for accrual and real-
based earnings
management for the
pre- and post-Higgs
bids with the method
of payment: current
accruals and real-
based earnings
management

significant at the 5 per cent level). Therefore, we find that cash bidders have more manipulation pre-Higgs using discretionary expenses as compared to stock bidders, and this difference is reduced in the post-Higgs period.

Table IX presents results using *A_TA* as the accrual manipulation measure. The results are slightly different from Table VIII. There is evidence that stock bidders engage in more income-increasing manipulation than cash bidders (coefficient of *A_TA* = 15.934; significant at the 5 per cent level) in the full sample. However, there does not appear to be any differences between pre- and post-Higgs periods, as the coefficient for *A_TA* × *POST-HIGGS* is insignificant in the final column. Furthermore, cash bidders engage in more income-increasing manipulation than stock bidders using real operating activities that reduce cash from operations and discretionary expenses (coefficient of *A_CFO* = 4.030,

Variable	Coefficient	p-value	Coefficient	p-value
Intercept	8.110**	0.037	24.689**	0.047
A_TA	<i>15.934**</i>	<i>0.012</i>	<i>60.908**</i>	<i>0.027</i>
A_CFO	<i>4.030**</i>	<i>0.018</i>	<i>17.555**</i>	<i>0.026</i>
A_DISX	<i>8.896***</i>	<i>0.006</i>	23.302	0.101
A_PROD	-1.058	0.370	10.866	0.195
POST-HIGGS			-2.957	0.405
A_TA × POST-HIGGS			-26.768	0.117
A_CFO × POST-HIGGS			-34.583**	<i>0.014</i>
A_DISX × POST-HIGGS			0.461	0.487
A_PROD × POST-HIGGS			-28.114**	<i>0.039</i>
PREM	-0.003	0.429	-0.074**	0.036
INDR	0.650	0.265	5.841**	0.045
SIZE	-1.186**	0.049	-2.943**	0.038
LEV	-5.056	0.112	-3.202	0.327
MTBV	-0.169*	0.072	-0.637**	0.023
OWN	-0.040*	0.065	-0.073	0.119
Industry dummies	YES		YES	
Year dummies	YES		YES	
N	107		107	
Likelihood ratio	74.377		94.826	
p-Value	0.001		0.001	

Notes: This table presents coefficients and p-values from logistic regressions of the form:

$$\begin{aligned}
 STK &= a_0 + a_1A_TA + a_2A_CFO + a_3A_DISX + \alpha_4A_PROD + \alpha_5PREM + \alpha_6INDR \\
 &+ a_7SIZE + a_8LEV + a_9MTBV + \alpha_{10}OWN + \sum \alpha_j IND + \sum \alpha_t year + \varepsilon \\
 STK &= a_0 + a_1A_TA + a_2A_CFO + a_3A_DISX + \alpha_4A_PROD + \alpha_5POST - HIGGS \\
 &+ \alpha_6A_CA(A_TA)*POST - HIGGS + \alpha_7A_CFO*POST - HIGGS \\
 &+ \alpha_8A_DISX*POST - HIGGS + \alpha_9A_PROD*POST - HIGGS + \alpha_{10}PREM \\
 &+ \alpha_{11}INDR + a_{12}SIZE + a_{13}LEV + a_{14}MTBV + \alpha_{15}OWN \\
 &+ \sum \alpha_j IND + \sum \alpha_t year + \varepsilon
 \end{aligned}$$

A_CA = Discretionary current accruals measured using Modified Jones Model with Kothari et al. (2005) modifications; A_TA = Discretionary total accruals measured using Modified Jones Model with Kothari et al. (2005) modifications; A_CFO = Abnormal Cash Flow from Operations; A_DISX = abnormal discretionary expenses; A_PROD = abnormal production costs; STK = dummy variable taking the value of 1 if the acquisition was financed by stock and 0 if financed by cash; PREM = percentage premium paid by the acquirer with respect to the target's share price four weeks prior to the announcement date as provided by Thomson One Banker; INDR = dummy variable for industry relatedness of the merging firms which takes the value of 1 if the acquirer and target have the same two-digit SIC codes; SIZE = size of the acquirer as measured by the log of its total assets, from Datastream; LEV = leverage as measured by the acquirer's total debt divided by total asset, both from Datastream; MTBV = market-to-book value of the acquirer defined as the market value of the common equity divided by the book value of the common equity the year before the merger announcement, both from Datastream; OWN = total percentage of shares held by outsiders holding 5% or more of total shares, from company's annual report; significant results for coefficients of accrual and real-based measures are marked in italics; ***, ** and * denote one-tailed significance at 1, 5 and 10% level, respectively

Table IX. Multivariate analysis for accrual and real-based earnings management for the pre- and post-Higgs bids with the method of payment: total accruals and real-based earnings management

significant at the 5 per cent level, and coefficient of $A_DISX = 8.896$, significant at the 1 per cent level). Across the two periods, cash bidders have higher income-increasing abnormal cash from operations in the pre-Higgs periods, which is reversed in the post-Higgs period (coefficient of $A_CFO = 17.555$, significant at the 5 per cent level, and coefficient of $A_CFO \times POST-HIGGS = -34.583$, significant at the 5 per cent level).

Overall, there is some evidence that in the full sample, stock bidders engage in income-increasing manipulation using accruals but not real activities. Furthermore, cash bidders engage in income-increasing manipulation using real activities (discretionary expenses) in the full sample. There are limited changes across the two periods before and after the Higgs enactment, which precludes a shift from accrual to real activities manipulation.

5. Conclusion

This study investigated accrual- and real-based earnings management for a sample of 197 UK acquiring firms from 12 different industries over the period 1990-2009. The findings of this study are somewhat consistent with those of [Erickson and Wang \(1999\)](#), [Louis \(2004\)](#) and [Botsari and Meeks \(2008\)](#) reporting evidence that stock-financed acquirers tend to report positive abnormal accruals prior to an M&A bid announcement. Furthermore, stock bidders engage in more positive accrual earnings management than cash bidders, as the latter lack the motivation to influence their share value before completing the bid.

The recommendations set out in the Higgs Report in 2003 are meant to restrain firms from engaging in accrual earnings management activities ([Iqbal and Strong, 2010](#)); [Habbash et al., 2013a, 2013b](#)). However, we find no evidence of significant differences in accrual manipulation in stock bidders between the post-Higgs and the pre-Higgs periods.

The results also reveal that cash bidders engage in real earnings manipulation through lower discretionary expenses, possibly to enhance cash availability for the bid. This study contributes to the literature by being the first to examine the incidence of pre-merger real-based earnings management as well as accrual-based earnings management by UK acquirers. It is also the first UK study to investigate earnings management behaviour around changes to the corporate governance environment. The findings of this study are of potential interest to policymakers, professionals and academics, especially in that the issue of earnings management in the UK is of great importance for these groups. This study gives these parties awareness about the engagement of UK acquirers in earnings management activities.

As with all research, there are limitations. First, this research focuses on a specific setting, M&As. Therefore, the findings may not be generalizable to other specific corporate events. In addition, a major focus of our empirical investigation is on the pre-merger accrual- and real-based earnings management of UK acquiring firms around changes in the UK corporate governance regime, brought about by the [Higgs \(2003\)](#) Report. Clearly the results associated with this strand of research might well not be applicable in other countries.

This study investigates accrual- and real-based earnings management for public acquiring firms that acquire public targets. Another avenue for further research is to investigate the same scenario of analysis when bidding firms acquire private targets, especially as different levels of information asymmetry may exist. Researchers can also examine real-based earnings management for other UK corporate events such as SEOs and IPOs.

Notes

1. We include only acquisitions that use one financing method for clearer results. However, in untabulated results, we also examine acquisitions financed by a combination of cash and stock and find no significant manipulation in this sample.

2. Results when these multiple acquisitions are included in the final sample are qualitatively the same.
3. Change in accounts receivable is subtracted from change in revenue in the estimation of normal accruals to take into account any possible discretion arising from credit sales (DeFond and Jambalvo, 1994).
4. Firm and year subsamples are not included for ease of presentation.

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