Chapter 4

Earnings Management and Mergers and Acquisitions: Empirical Evidence From Italian–Listed Companies

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ABSTRACT

This chapter investigates whether Italian-listed companies involved in mergers and acquisitions (M&A) during the period 2009–2017 manipulated earnings through recourse to discretionary accruals in response to financial market competition. Interest in the possible effects of competition on earnings management practices follows the considerable attention attracted by the effects of business combinations on disclosure quality and reliability. M&A represents an opportunity for managers to manipulate financial reports and to deliver misleading market information in order to enhance company reputation and attract funds from investors. This empirical analysis demonstrates that Italian-listed companies involved in M&A used goodwill as a discretionary accrual for managing earnings. The findings indicate that the increasing level of financial market competition between Italian-listed companies prompted major recourse to earnings management practices based on discretionary accruals.

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INTRODUCTION

In recent decades, numerous empirical accounting studies have discussed the determinants and consequences of financial disclosure quality, which are often linked to earnings quality (e.g. Schipper & Vincent, 2003; Dechow, Weili, & Schrand, 2010; Kothari, 2001). Managers’ decisions concerning the appropriate level of disclosure involve a trade-off between the benefits of informing the capital market about the firm’s value and the costs of aiding its rivals (Cheng, Man, & Yi, 2013, p. 140). On the other hand, the demand for financial disclosure arises from an asymmetry between the quantity and quality of business information held by firm insiders and what external stakeholders effectively perceive through disclosure (e.g. Lang & Lundholm, 1996; Healy & Palepu, 2001).

Many areas of the accounting literature on earnings quality address the potential influence of governance, fiscal, ethical and auditing variables on strategic earnings management choices while ignoring environmental macroeconomic factors (e.g. Jiang, Zhu, & Huang, 2013; Sundvik, 2017; Shleifer, 2004; Badolato, Donelson, & Ege, 2014). These analyses offer only a partial view because they assume that the economic background remains the same and does not influence either accounting choices or the stability of financial markets (Filip & Raffournier, 2014).

Analyses of the effects of macroeconomic features on earnings quality have yielded mixed empirical results in relation to how they influence managerial accounting behaviour. In certain circumstances, such macroeconomic features have been found to incentivize strategic manipulation of earnings (Burgstahler, Hail, & Leuz, 2004; Bushman & Piotroski, 2006; Filip & Raffournier, 2014; Persakis & Iatridis, 2014). Some of the most investigated environmental proxies are linked to financial market trends. For example, Kane, Richardson and Graybeal (1996) and Richardson, Kane and Lobinger (1998) proved that both quantity and quality of financial disclosure are profoundly influenced by economic recession. In contrast, a more recent study by Filip and Raffouriner (2014) provided evidence that earnings management practices decreased in those countries impacted by the global financial crisis. There is also evidence that key characteristics of business cycles, such as periods of expansion and contraction, influence disclosure quality (Johnson, 1999; Jenkins, Kane, & Velury, 2009). However, more research is needed to fully understand the effects of macro-economic features on earnings and disclosure quality.

Despite the risk of reputational damage, recourse to earnings manipulations have been identified even when stakeholders are fully focused on the information contained in financial reports. Business combinations (corporate strategic decisions involving plural economic identities) are strategic market operations implemented to change relevant market situations and strategic positioning. While some empirical studies have investigated the determinants of unethical managerial accounting practices in takeover and merger settings (Easterwood, 1998; Erickson & Wang, 1999), there is little evidence in relation to the effects of a given macroeconomic proxy (such as financial market competition) on recourse to earnings management during mergers and acquisitions (M&A) business combinations.

The objective of the present study is to investigate whether Italian-listed companies involved in M&A during the period 2009–2017 manipulated reported earnings through the use of discretionary accruals in response to financial market competition, focusing in particular on goodwill recognition and impairment. Our interest in investigating the role of competition in earnings manipulations during business combinations derives from stakeholders’ focus on the quality of information disclosures by companies involved in such operations (e.g. Bens, Goodman, & Neamtiu, 2012). M&A present an opportunity for managers to manipulate financial reports by adopting earnings management policies such as income