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Earnings Management and the Effect on Long-Run Performance for Firms With Seasoned Equity Offerings

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EARNINGS MANAGEMENT AND THE EFFECT ON LONG-RUN PERFORMANCE FOR FIRMS WITH SEASONED EQUITY OFFERINGS

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Managers of publicly traded firms use various methods to signal to the market their beliefs about their company's current performance and future prospects. These methods include, among others, the declaration of dividends to common stockholders, a firm's repurchase of its shares in the market, or the issuance of seasoned equity. Each of these actions can be used to send a specific signal to the market based on management's beliefs regarding the firm's financial outlook.

This study focuses on a firm's issuance of seasoned equity. Seasoned equity offerings, or SEOs, are the issuance of additional shares of stock by a firm that is already publicly traded. These issuances are typically made in order for the firm to generate the additional funds necessary to finance a potential project or projects.

Firms can generate additional funds in several ways, and projects may be funded through the use of not only one, but in some instances a combination of sources. Based on a firm's desired capital structure and its relative costs of debt and equity, it may issue bonds, common stock, preferred stock, or a combination of other forms of debt or equity. When firms employ the issuance of seasoned equity to raise funds, it is a signal to the market that management believes the shares of the company's stock are overvalued. By selling additional shares when an artificially high price can be obtained, the company will be able to generate more funds from the issuance.

The direct correlation between stock price and fund generation by the firm can create incentives for managers. As such, in the time leading up to the announcement of a firm's issuance of seasoned equity, management has an incentive to inflate the company's stock price in an effort to obtain a high price for its shares. This can be accomplished through the use of earnings management.

Earnings management has long been studied by academics. It is evident that managers have an incentive to inflate or deflate earnings in order to align them with analysts' expectations. Within the constraints of the Financial Accounting Standards Board (FASB)'s Generally Accepted Accounting Principles (GAAP), managers have the ability to manage earnings up or down through, among other things, the use of discretionary accruals.

Discretionary accruals, as their name implies, involve the use of discretion. The judgment required in relation to these accruals allows management to inflate or deflate earnings in a given period should they choose to do so. The management of these accruals and the employment of the upward management of earnings are of particular benefit to the firm in the period before it announces a seasoned equity offering. Should the firm be able to successfully manage their earnings upward before the issuance of equity, they receive a higher price for their shares.

Discretionary accruals reverse when revenues and expenses are recognized in later periods, thus disallowing management to artificially inflate earnings for an extended period of time. While there is a benefit to the upward management of earnings prior to the issuance of seasoned equity, the increases in earnings in one period result in decreases in later periods. These decreases result in lower earnings following the issue and can lead to lower stock prices as a result of the market's reaction to the earnings decline.

This study focused on firms that have issued seasoned equity, which are suspected to have managed earnings. For these firms, an examination of the extent to which their employment of earnings management caused negative stock price reactions was conducted. The purpose of this study was to determine to what extent the employment of earnings management affected the amount of negative stock price reaction. An analysis of the stock price reaction over

the twelve months following the announcement was given special attention as this is when discretionary accruals are expected to reverse. The results allow for the development of conclusions regarding the use of earnings management prior to seasoned equity offerings and whether or not the accruals used are recognized by the market and included in the stock's issue price.

Literature Review

Definition of Earnings Management

Earnings management typically refers to the management of earnings within the constraints of U.S. Generally Accepted Accounting Principles (GAAP), and has long been studied by academics (Burgstahler & Dichev, 1997). Beneish (2001) presents three definitions of earnings management based upon the work of others:

> Managing earnings is "the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings." (Schipper, 1989, p. 92).

> Managing earnings is "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to say, merely facilitating the neutral operation of the process… a minor extension of this definition would encompass "real" earnings management, accomplished by timing investment or financing decisions to alter reported earnings or some subset of it" (Schipper, 1989, p. 92).

> "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (Healy & Wahlen, 1999, p. 368).

While each of the definitions presented by Beneish (2001) exhibited a negative connotation, Laux (2003) suggested that earnings management is a "continuum, with economic reality as reflected through appropriate GAAP-approved choices at one end and intentional revenue/asset overstatement (or expense/liability understatement), i.e. fraudulent reporting at the other" (p. 2). She also noted that earnings management is desirable to a certain extent when used to smooth income across years and minimize extreme peaks and troughs related to earnings (Laux, 2003).

Regardless of the way earnings management is defined, managers have many incentives to engage in earnings management. Jackson and Pitman (2001) identified three types of incentives that can induce a firm's management to manage earnings. The three types of incentives identified were contractual, market, and regulatory. Contractual incentives included things such as management compensation and debt covenants that were tied to a firm's earnings, market incentives included management's desire to smooth earnings in an effort to minimize negative stock price reactions to earnings reports, and regulatory incentives related to management's potential ability to effect government regulations.

Types of Earnings Management

Just as there are many ways to define earnings management, there are also many ways in which it can be divided and categorized. Furthermore, studies have shown that certain types of earnings management can to be more successful in accomplishing management's goals than others (Kim & Park, 2005; Rangan, 1998; Teoh et al., 1998).

Cohen and Zarowin (2010) divided earnings management into two categories: accrual and real. Real earnings management encompassed changes made that have a direct effect on cash flows, such as the purchase of additional capital expenditures or the use of sales discounts to increase sales figures in a particular year. Real earnings management has at least one benefit over accrual-based earnings management. While accrual-based earnings management relates to management expectations, real earnings management affects cash flows. Cohen and Zarowin (2010) pointed out that accrual-based earnings management is more likely to be detected than real earnings management, and the extent to which firms engage in accrual-based earnings management can be explained by a function of several factors. Cohen and Zarowin's (2010) study identified the following factors as being "associated with an increased tendency to use real earnings management around the time of the SEO: the presence of a Big 8 auditor, longer auditor tenure, being in a high-litigation industry, and the level of net operating assets" (p. 15). The indicator with the largest effect was found to be the firm's level of net operating assets (NOA) due to the fact that a high level of NOA allows the firm increased flexibility in its spending.

The other category of earnings management studied by Cohen and Zarowin (2010) was accrual-based earnings management. Accrual-based earnings management stems from a firm's use of accruals to more accurately present the financial position of their business to users of the

financial statements. This includes accruals related to bad debts, deferred tax assets, contingencies, and other potential liabilities (or contra assets) recognized by the firm related to its transactions in the current year. By decreasing these accruals in the year before a seasoned equity issuance, expenses recognized for the year are also decreased, therefore increasing current income. When these accruals reverse, the expenses are recognized, therefore decreasing net income.

Accrual-based earnings management has been the focus of much earnings management research (Kim & Park, 2005; Rangan, 1998; Teoh et al., 1998). As noted by Jackson and Pitman (2001), "by their nature, accruals involve estimation, require subjective judgments, and are difficult for auditors to objectively verify before their realization" (p. 2). The accruals studied can be further divided into current or long-term and discretionary or non-discretionary, as was done by Teoh et al. (1998), in order to isolate the type of management being used. In the context of accounting, 'current' refers to assets, liabilities, revenues or expenses expected to be realized within one year or one operating cycle. Long-term, on the other hand, refers to those events that are not expected to affect income within one year or one operating cycle. Discretion can be defined as "individual choice or judgment and the power of free decision or latitude of choice within certain legal bounds" (Discretion, n.d.). Therefore, discretionary accruals relate to those that require management judgment. Non-discretionary accruals, however, do not contain such judgment.

Long-Run Performance of Firms with Seasoned Equity

Regardless of the type of earnings management used, its employment can be particularly beneficial to firms in various situations, including, but not limited to, the period leading up to a

firm's issuance of seasoned equity. While many studies relate a firm's underperformance to its use of earnings management prior to the seasoned equity issue, Shivakumar (2000) found that the amount of earnings management employed has already been priced in the market. Further, she noted that investors have identified a firm's management of earnings even before an equity offering is announced and have thus already included it in their stock price estimates and investment decisions.

The prevalence of the employment of earnings management prior to a firm's season equity offering has been documented by various studies (Kim & Park, 2005 and Rangan, 1998). The use of earnings management to increase a firm's earnings prior to a seasoned equity offering causes analysts to overvalue the firm, which in turn results in the firm receiving an artificially high price for its shares (Kim & Park, 2005 and Rangan, 1998). Kim and Park's 2005 study found that this is due to the direct correlation between the offering's issue price and the issuer's wealth.

Due to the nature of discretionary accruals, the overvaluation obtained by the firm at issuance subsequently reverses itself. This overvaluation is exemplified by the poor financial performance of seasoned equity issuing firms following the offering as noted by various studies (Eberhart & Siddique, 2002; Loughran & Ritter, 1997; Rangan, 1998; Spiess & Affleck-Graves, 1995; Teoh et al., 1998). Furthermore, Cohen and Zarowin (2010) also found that the underperformance of firms following their seasoned equity offering consists of both real and accrual-based earnings management.

The phenomenon of increases in a firm's stock price in the period preceding a seasoned equity issue and a subsequent decline in price in the period following the seasoned equity issue has been documented by various studies including one by Rangan (1998). Additionally, studies

such as the one conducted by Cohen and Zarowin (2010) find that "SEO firms tend to both outperform their industry peers in the period preceding the SEO and underperform their peers following the SEO, as evidenced by their returns on assets" (p. 3). Research by Kalay and Shimrat (1987) supported an information release hypothesis. This hypothesis indicated that when firms issue equity, the market believes it to be a negative signal (Kalay & Shimrat, 1987).

Studies such as Teoh et al. (1998) have shown that the accrual-based earnings management category that relates most closely with the underperformance of seasoned equity offerings following their issuance is the use of current discretionary accruals. Teoh et al. (1998) also found current discretionary accruals to predict lower future earnings and in turn stock price underperformance. Rangan (1998) expanded upon this and noted that discretionary earnings management can be used to explain a portion of the decline in the stock price in the year following the issue.

Cohen and Zarowin (2010) studied both accrual and real earnings management surrounding seasoned equity issuances. They too found that firms that engaged in earnings management outperformed their peers before the seasoned equity offering and underperformed their peers following the offering. Their study, however, focused on the use of real earnings management rather than accrual. In doing so, the study identified a firm's successful use of real earnings management to be more likely to be related to decreased performance following a seasoned equity issuance than its use of accrual-based earnings management.

Further, Rangan (1998) found changes in earnings in periods more than one year after the offering date to be unrelated to the discretionary accruals found in the year of issuance. Although Loughran and Ritter (1997) did not distinguish between types of accruals, they did, however, note that firms that issue seasoned equity experience a peak in performance at the time

of their issuance of seasoned equity. The study also examined the firms' profitability ratios and found increases in the ratios before the offering and declines in the ratios following the offering (Loughran & Ritter, 1997).

As various studies have shown, seasoned equity offerings result in negative abnormal returns to shareholders following the issue (Cohen & Zarowin, 2010; Eberhart & Siddique, 2002; Loughran & Ritter, 1997, Rangan, 1998; Spiess & Affleck-Graves, 1995; Teoh et al., 1998).

Hypotheses

This study set out to investigate whether or not, and to what extent, earnings management can affect seasoned equity offerings. This was measured by use of a ranking system in which firms were ranked based on the amount and direction of their current discretionary accruals. The accruals were measured based on the firm's financial statements of the period before their announcement of a seasoned equity issuance.

By comparing firms with seasoned equity offerings over a three-year time period, the sample selected will produce similar results to those of other studies (Eberhart & Siddique, 2002; Kalay & Shimrat, 1987; Rangan, 1998; Spiess & Affleck-Graves, 1995; Teoh et al., 1998). Based on the results of previous studies, this study will develop conclusions based on the following hypothesis:

1. *Firms that issue seasoned equity will experience negative abnormal returns following issuance of seasoned equity*

Managers have an incentive to engage in earnings management when they believe their stock is undervalued by the market. By using discretionary accruals to increase their earnings, management's perception of the firm's value can be more adequately reflected in its stock price. Further, when managers consider their stock to be overvalued by the market, they have an incentive to raise capital by issuing more shares through a seasoned equity offering. This is due to the correlation between stock price and the amount of proceeds the firm receives during the issuance. Any proceeds that exceed the par value of the common stock issued increase the additional paid in capital account of the firm, which therefore increases total stockholders' equity.

Following seasoned equity issues, firms have been shown to underperform their peers (Cohen & Zarowin, 2010; Eberhart and Siddique, 2002; Loughran and Ritter, 1997; Rangan, 1998; Spiess and Affleck-Graves, 1995; Teoh et al., 1998). It is believed that this is due to the firm's use of earnings management to increase stock price prior to a seasoned equity issuance. Therefore, the extent to which earnings management is used should have an effect on the degree of underperformance. As a result, this study developed conclusions based on two additional hypotheses:

2. *Firms that engage in earnings management through the use of income-increasing accruals prior to the issuance of seasoned equity will experience larger negative returns than their peers that also issue seasoned equity.*

3. *Firms that engage in earnings management through the use of income-decreasing accruals prior to the issuance of seasoned equity will experience less negative returns than their peers that also issue seasoned equity.*

Methodology

Using a data ranking of firms based on the amount of discretionary accruals present in their financial statements for a given year, a comparison was made between those with strong positive adjustments to income and those with strong negative adjustments to income. The abnormal returns from these groups were examined for the days around the announcement date of their seasoned equity issuance and up to three years subsequent to the announcement date. These returns were then compared for each quintile as well as the sample as a whole and tested for statistical significance.

The exchanges on which the firms included in the sample trade operate Monday through Friday during the calendar year, excluding holidays. This means that there are typically 252 trading days each year based upon the day of the week when national holidays fall. This number was taken into account when calculating cumulative mean abnormal returns.

By limiting the sample to those firms suspected of earnings management, this study addressed whether or not earnings management plays a role in the negative stock price reactions and stock underperformance following seasoned equity offerings. This study is most interested in the performance of the group of firms as a whole compared with those that engaged in positive earnings management and those that engaged in negative earnings management.

Selection of Sample Data and Determination of Rankings

Data included in this study are from those firms included in a ranking of firms by Mason-Olsen and Zaman (2005) in their study of firms from 1978-2000. The ranking computation was based on a modified Jones (1991) model in order to focus on short-term accruals rather than long-term accruals. Short-term accruals were the focus of the rankings as they can more easily managed than long-term accruals and their effects can be seen in the year subsequent to their management, making them more easily examined.

The ranked firms were then matched with those that issued seasoned equity between 1995 and 2000. Seasoned equity issuances of secondary shares were excluded from the sample as were issuances of shares other than common shares. This was done in an effort to more clearly identify changes in stock prices for common shares issued during a primary offering as they are the most actively traded. This resulted in a sample of 282 firms.

The ranking of each firm was matched with the firm's seasoned equity filing date in the year following the ranking. This allows the ranking to reflect the amount of discretionary accruals present in the firm's financial statements in the period just prior to the issuance.

Sample selection for this study was based upon the ranking of firms discussed above in relation to the extent of each firm's use of discretionary accruals in the year prior to the filing date. The highest ranking (1) corresponds with income-decreasing accruals while the lowest ranking (5) corresponds with income-increasing-accruals. Firms that employed income-decreasing accruals managed their earnings downward while those that engaged in income-increasing accruals managed their earnings upward prior to the seasoned equity offering. This inflation or deflation of earnings as well as its extent was the focus of the analysis conducted in this study.

Characteristics of Sample

The total number of firms included in the sample was 282. The sample's average offer size was $94,188,695. The average market value of equity of firms included in the sample was $753,553,318. As shown in Table 1, firms were relatively evenly dispersed between each of the five quintiles. The first quintile, which contains firms with the largest income-decreasing accruals, contains 65 firms. The second quintile contains 51 firms, while the third, fourth, and fifth quintiles contain 51, 35 and 80 firms respectively.

Average offer size was examined in order to determine whether or not inferences could be made regarding the correlation between the firm's offer size and their use of discretionary accruals. Firms with the highest average offer sizes were those of quintiles 1 and 4 which exhibited average offer sizes of $120,450,645 and $116,143,973 respectively. While these firms had the highest average offer sizes, they also had significantly larger market values of equity on the announcement date as compared to the other firms in the sample. Quintile 1 firms had an average market value of equity of $710,715,612 while Quintile 4 firms had an average market value of equity of $2,615,388,417. Therefore, the relationship between average offer size and market value of equity was also examined.

The percentage of total market value of equity that was offered as seasoned equity by a firm was computed using the average offer size and average market value of equity for each quintile. This shows that although quintiles 1 and 4 exhibit larger offer sizes, they also have larger market values of equity and in turn lower percentages of their total equity being offered in their seasoned equity offering. Percentages of equity offered were 16.95% and 4.44% for quintiles 1 and 4 respectively.

As a percentage of the market value of the firm, firms in quintile 5 offered the largest amount of equity in their seasoned equity offering. Average offer size divided by average market value of equity for Quintile 5 was 29.19%. This indicates that this quintile had the most to gain or lose as a result of the offering, and therefore should presumably have the largest incentive to manage earnings upward to achieve a higher stock price at the time of issuance. Quintile 5's average discretionary accruals, as measured by Mason-Olsen and Zaman (2005) were the largest of all firms included in the sample. This was due to the firms being ranked by the amount of discretionary accruals present in their financial statements in the year prior to the announcement of their seasoned equity issuance.

Table 1: Average Offer Size and Market Value of Equity

	# Firms	Average Offer Size	Average MVE	% Offered
All	282	$94,188,695	$753,553,318	12.50%
Group 1	65	$120,450,645	$710,715,612	16.95%
Group 2	51	$75,398,925	$394,316,103	19.12%
Group 3	51	$98,001,886	$680,334,063	14.40%
Group 4	35	$116,143,973	$2,615,388,417	4.44%
Group 5	80	$72,792,997	$249,355,838	29.19%

Computing the minimum, median, and maximum offer size and market value of equity for the firms in total as well as for each quintile shows quintile 5 to have the smallest range for offer size ($388,450,000) and market value of equity ($1,666,183,000. Dispersion between minimum and maximum offer size for each quintile yielded offer size dispersion of $1,908,909,925, $682,128,609, $406,375,000, $414,389,575, and $388,450,000 for quintiles 1 through 5

respectively. Market value of equity dispersion was computed as the difference between the minimum and maximum market value of equity for each quintile and resulted in dispersion amounts of $15,340,176,125, $6,295,386,192, 3,996,358,500, $71,310,515,500 and $1,666,183,000 for quintiles 1 through 5 respectively. Therefore, while the fifth quintile does not have the highest average offer size or highest market value of equity, the firms that are found in this quintile are more closely related to each other in terms of size and offer size when compared with the firms in other quintiles.

Table 2: Offer Size and MVE Characteristics

	Minimum Offer Size	Median Offer Size	Maximum Offer Size	Minimum MVE	Median MVE	Maximum MVE
All	$184,000	$56,756,250	$1,903,310,000	$5,650,308	$155,888,188	$71,328,187,000
Group 1	$400,075	$48,000,000	$1,903,310,000	$10,043,875	$141,522,750	$15,350,220,000
Group 2	$184,000	$55,100,000	$682,312,609	$5,650,308	$186,993,000	$6,301,036,500
Group 3	$7,500,000	$64,470,000	$413,875,000	$6,004,875	$186,993,000	$4,002,363,375
Group 4	$1,452,000	$67,299,356	$415,841,575	$17,671,500	$262,641,750	$71,328,187,000
Group 5	$4,800,000	$46,450,000	$393,250,000	$6,125,000	$142,865,000	$1,672,308,000

Table 3: Range of Offer Size and Market Value of Equity

	Offer Size Range	Market Value of Equity Range
All	$1,909,126,000	$71,322,536,692
Group 1	$1,908,909,925	$15,340,176,125
Group 2	$682,128,609	$6,295,386,192
Group 3	$406,375,000	$3,996,358,500
Group 4	$414,389,575	$71,310,515,500
Group 5	$388,450,000	$1,666,183,000

Results

Announcement Date Returns

A negative stock price reaction was expected surrounding the announcement date of a seasoned equity offering. The issuance of seasoned equity indicates to the market that management believes the firm's stock price is overvalued and has chosen to obtain financing through the use of equity rather than the use of debt. The sample used in this study exhibited the attributes anticipated.

Mean cumulative abnormal returns were first computed for the sample as a whole (income-increasing, income-decreasing, and little to no accrual firms). Returns for the period one day prior to one day subsequent to the announcement date of the seasoned equity issue were slightly negative at the .001 level of significance. Returns were negative and statistically significant for all but the second and third quintiles, which exhibited slightly positive returns. Median returns were negative for each quintile for the same three-day time period. This indicates a negative stock price reaction to the announcement of a seasoned equity issue, as was hypothesized by this study. Various other studies have also found negative stock price reactions to the announcement

of a seasoned equity issue including those by Eberhart & Siddique (2002), Kalay & Shimrat (1987), Rangan (1998), and Teoh et al. (1998).

Table 4: Announcement Date Returns Trading Days (-1, +1)	
All	-1.35%
Group 1	-2.77%
Group 2	0.46%
Group 3	0.03%
Group 4	-1.67%
Group 5	-1.31%

Discussion of Long-Run Performance

Year 1 Returns.

After conducting a thorough analysis of stock price reactions surrounding the announcement date of the seasoned equity issuance, returns were computed for various time frames following the issuance. Over these time frames, firms included in the sample exhibited negative returns for one, two, and three years following the issuance. This study focused on returns over the one-year time period following the issuance as this is the time period in which the discretionary accruals used by management are expected to reverse.

Returns for trading days +25 to +252 following the issuance of seasoned equity show firms to exhibit negative returns. Studies by Eberhart & Siddique (2002), Rangan (1998), Spiess & Affleck-Graves (1995), and Teoh et al. (1998) also found firms to experience negative returns in the year following a seasoned equity offering. In regards to this study, mean cumulative abnormal returns were the greatest for the sample as a whole in the +25 to +252 day time period. Based on a 252-day trading year, this time period represents returns from one month following

the announcement date to one year following the announcement date. This time period is expected to exclude stock price reactions due to the announcement, as they were included in the analysis of announcement date returns above. Therefore, we see the largest negative stock price reaction during this time frame. This accounts for just over one-third of the negative cumulative abnormal return for the entire three-year period studied.

Firms in the fifth quintile exhibited the largest negative cumulative abnormal return during the first year following issuance. The -76.90% cumulative abnormal return represents just over 38% of the decline recognized by the quintile over the three-year period following the issuance. This shows that the most significant effects of the issuance are reflected in stock prices in the one-year period following the issuance. This is the time-period over which the firm's discretionary accruals in the previous year's financial statements are expected to reverse. This reversal contributes to the negative stock price reaction. This helps to explain why we see the largest negative returns in the fifth quintile of the sample. Again, these firms are those that have the highest amount of income-increasing discretionary accruals. This supports the hypothesis that firms that engage in income-increasing earnings management experience larger negative cumulative abnormal returns than their peers.

Further support of the aforementioned hypothesis can be found by examining the returns of those firms in Quintile 3. These firms are ranked in the middle of the sample, and exhibit very few discretionary accruals. If they do engage in the use of discretionary accruals, the income-increasing and income-decreasing accruals nearly offset each other, resulting in a very small amount of discretionary accruals. This quintile also exhibited the lowest negative returns of the sample over the one-year time period following their seasoned equity issuance. Additionally, the quintile's negative cumulative abnormal return was less than half of the average negative

cumulative abnormal return for the entire sample. Those firms that do not engage in earnings management in order to either increase or decrease stock price prior to the issuance of seasoned equity do not experience the increases or decreases in earnings following the reversal of the accruals. Therefore, earnings presumably remain relatively stable over time and therefore contribute to the decreased level of negative abnormal returns.

Table 5: Year 1 Returns (Trading Days +25, +252)	
All	-56.62%
Group 1	-61.99%
Group 2	-42.69%
Group 3	-24.85%
Group 4	-66.32%
Group 5	-76.90%

Year 2 Returns.

The second year returns for the sample of firms are generally less negative than the first year returns, with the exception of the first quintile. Other studies that have found firms which have offered seasoned equity to experience negative stock returns two years following issuance include Eberhart & Siddique (2002), Spiess & Affleck-Graves (1995), and Teoh, et al. (1998). Without further analysis and identification of the individual firms included in the sample and their individual business factors and announcements, a conclusion regarding the reasoning for this exception cannot be made. This analysis is outside the scope of this study as the study does not attempt to explain each individual anomaly.

Table 6: Year 2 Returns (Trading Days +253, +504)	
All	-54.47%
Group 1	-72.70%
Group 2	-32.08%
Group 3	-22.58%
Group 4	-54.63%
Group 5	-74.47%

Year 3 Returns.

The sample of firms were ranked based on short term accruals, however it is likely that those with high current accruals will engage in long-term accruals management to the extent they are able to in an attempt to artificially inflate or deflate stock price at the time of issuance. As previously mentioned, other studies have documented negative returns in the long-run for firms that issue seasoned equity. This study also shows negative long-run returns for firms that issue seasoned equity, regardless of the amount of their use of current discretionary accruals in the period prior to the seasoned equity issuance. Table 7 shows cumulative abnormal returns for the third year following a firm's seasoned equity issuance (trading days 505 to 757 following the announcement date) to be negative for each individual quintile as well as for the sample as a whole. Studies by Eberhart & Siddique (2002), Spiess & Affleck-Graves (1995), and Teoh et al. (1998) also produced negative returns for seasoned equity offering firms in the third year following the issuance.

The trends of the sample firms' negative cumulative abnormal returns in the third year introduce several characteristics that may or may not represent the returns related to a firm's issuance of seasoned equity. Computing long-run returns for the firms increased the extent of

long-run accrual reversal, but also introduced the possibility of other factors affecting stock price to be included in the calculation, rather than just the reversal of discretionary accruals.

Over time, many factors can affect a firm's stock price. These factors can result from events within the firm or events outside the firm that may or may not impact its operations. Examples of firm events include a change in strategic direction, acquisition of or mergers with other companies, or other changes in the way operations are conducted. Examples of other factors that may affect stock prices without being related to the individual firm's operations include macroeconomic factors such as interest rates, inflation, deflation, or economic booms or recessions. These factors can influence individual firms differently based upon the type of goods or services they provide.

Table 7: Year 3 Returns (Trading Days +505, +757)	
All	-48.76%
Group 1	-52.77%
Group 2	-45.02%
Group 3	-29.41%
Group 4	-56.30%
Group 5	-57.19%

Cumulative Returns.

Returns for the three-year period beginning on the announcement date are highly negative, with those returns for the fifth quintile being the most negative. This further supports the hypotheses noted in this study. It shows that firms that issue seasoned equity experience negative cumulative abnormal returns following the issuance, and that the return is more

negative for those in the fifth quintile that engage in earnings management through the use of income-increasing short-term discretionary accruals.

Table 8: Cumulative Returns		
	(+25, +757)	(0, +757)
All	-152.64%	-157.04%
Group 1	-176.29%	-181.13%
Group 2	-115.38%	-118.85%
Group 3	-72.43%	-75.35%
Group 4	-168.13%	-171.23%
Group 5	-201.99%	-208.20%

Discussion

Delimitator

This study originally set out to examine the wealth transfer hypothesis. It intended to identify not only the significance of negative abnormal returns to shareholders following a seasoned equity issuance, but also the increase in wealth to bondholders as a result of the issuance. However, due to time constraints, the study was forced to focus on abnormal equity returns alone instead of both equity and debt returns.

Recommendations for Future Research

Those that experience declines in their wealth have been identified in this study. An investigation into the bond price returns of the firms included in this study should be conducted in order to determine whether or not, and to what extent a wealth transfer hypothesis holds due to a firm's issuance of seasoned equity. This analysis would help to identify which groups benefit from a firm's seasoned equity issuance.

The issuance of additional equity through a seasoned offering changes the debt to equity ratio of the firm and subsequently the weighted average cost of capital and risk of the firm. A firm's cost of equity is typically higher than its cost of debt due to double taxation and the increased risk associated with equity holdings as opposed to debt. In the case of bankruptcy, for instance, bondholders are paid first, with any remaining funds distributed to common shareholders only after all creditors and preferred stockholders are paid in full.

Debt is generally a less costly way to finance a firm's capital requirements. In addition to the lower rates of return required, interest payments are tax deductible to the firm whereas dividends paid to common stockholders are subject to double taxation. This means that the firm pays tax on the income it generates. The income remaining after taxes are paid is then available to pay out to shareholders through cash dividends. Should a firm decide to pay out dividends, the dividends are included in the income of the shareholder when they are received and taxed again.

By increasing the amount of equity in the capital structure via a seasoned equity offering, the risk associated with holding the company's debt decreases as a result of decreased leverage. This presumably leads to a decrease in bond prices, and therefore higher returns to bondholders. This increased return to bondholders, coupled with the stock price declines found in this study, would substantiate a wealth transfer hypothesis.

Additional analysis should therefore be conducted related to the firms' bond price reactions during the same time periods as was studied using equity returns. This would identify whether or not there was a transfer of wealth from shareholders to bondholders as a result of a seasoned equity issuance. Positive abnormal returns to bondholders over the same time period analyzed in this study would indicate the existence of wealth transfer.

Conclusion

The negative long-run performance of firms following a seasoned equity offering has been documented by various studies (Cohen & Zarowin, 2010; Eberhart & Siddique, 2002; Loughran & Ritter, 1997; Rangan, 1998; Spiess & Affleck-Graves, 1995; Teoh et al., 1998). This study set out to investigate whether or not, and to what extent, the use of earnings management affects seasoned equity offerings.

Within the constraints of the Financial Accounting Standards Board (FASB)'s Generally Accepted Accounting Principles (GAAP), managers have the ability to manage earnings up or down through, among other things, the use of discretionary accruals. Using a data ranking of firms based on the amount of discretionary accruals present in their financial statements in the year prior to their seasoned equity issuance, a comparison was made between those with strong positive adjustments to income and those with strong negative adjustments to income.

As hypothesized, this study found firms that issue seasoned equity experience negative cumulative abnormal returns following their issuance. The prevalence of negative abnormal returns for all firms following seasoned equity issues was confirmed at a .01 level of significance. This supports the study's first hypothesis that firms that issue seasoned equity experience negative abnormal returns following their issuance of seasoned equity.

This study shows that those firms that engaged in positive earnings management exhibited larger negative excess returns than those of their peers. This can be explained largely by their use of income-increasing accruals to artificially inflate stock prices near the issue date of the new shares in order to generate additional inflows from the issue. The subsequent reversal leads to perceived underperformance of the firm due to the recognition of accruals that were deferred to a

subsequent year. This underperformance leads to stock price declines and in many instances negative cumulative abnormal returns for the firm following its seasoned equity issuance.

A comparison was also made between those firms that employed income-increasing accruals in the year prior to issuance and those firms that employed income-decreasing accruals in the year prior to issuance. Firms with large income-increasing accruals in the year prior to seasoned equity issuance exhibit statistically significant negative excess returns in each year following the issuance. This supports the hypotheses that firms that engage in income-increasing accruals prior to seasoned equity issuance experience larger negative returns and those that engage in income-decreasing accruals experience less negative returns. This can be explained by the nature of discretionary accruals. Short-term discretionary accruals typically reverse themselves in the year following their employment. This means that any increase in earnings achieved by the firm before its seasoned equity issuance is subsequently reversed in the year following the issuance. This can cause earnings declines that are unexpected by the market and therefore lead to stock price declines. This was proven by the negative cumulative abnormal returns for the sample of seasoned equity issuing firms as well as negative cumulative abnormal returns for each quintile studied.

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