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EARNINGS MANAGEMENT AND SEASONED PRIVATE EQUITY
PLACEMENTS: EVIDENCE FROM U.S. AND JAPANESE ISSUERS

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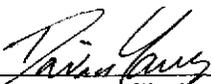
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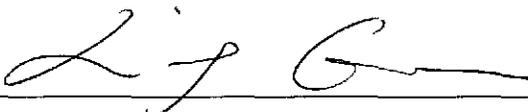
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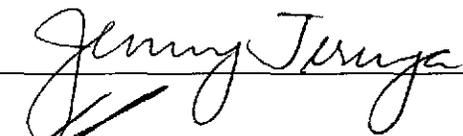
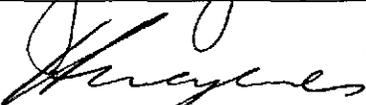
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ABSTRACT

Seasoned private equity placement is an important vehicle by which public firms obtain equity financing. This study seeks to accomplish three goals regarding the issuance of private placements: (1) to investigate managers' earnings manipulation behavior of U.S. issuers around the time of the issuance; (2) to examine whether such earnings manipulation behavior helps explain the long-term post-issue stock underperformance; and (3) to provide further evidence from Japanese private placement issuers regarding the pattern of earnings management around the time of issuance and the extent to which it can explain the post-issue stock underperformance. The results show that managers of U.S. private placement issuers tend to engage in income-increasing earnings management around the time of the issuance and the income-increasing accounting accruals made at the time of private placements predict the post-issue stock underperformance. The study also finds that, similar to their U.S. counterparts, Japanese managers tend to report inflated earnings around the time of private placements issuance and the earnings management by Japanese private placement issuers in the year of issuance predicts the firm's post-issue stock underperformance.

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LIST OF ABBREVIATIONS

AMEX	American Stock Exchange
CEO	Chief Executive Officer
CRSP	Center for Research in Security Prices
DA	Discretionary Accruals
GAAP	Generally Accepted Accounting Principles
IPO	Initial Public Offerings
NASDAQ	National Association of Securities Dealers Automated Quotation
NDA	Nondiscretionary Accruals
NYSE	New York Stock Exchange
PACAP	Pacific-Basin Capital Markets Database
ROA	Return on Assets
SEC	Security and Exchange Commission
SEO	Seasoned Public Offerings
SIC	Standard Industrial Classification
TA	Total Accruals

CHAPTER 1 INTRODUCTION

This study seeks to accomplish three goals regarding the issuance of private placements of common equity (hereafter, *private placements*): (1) to investigate managers' earnings manipulation behavior of U.S. issuers around the time of the issuance; (2) to examine whether such earnings manipulation behavior helps explain the long-term post-issue stock underperformance; and (3) to provide further evidence from Japanese private placement issuers regarding the pattern of earnings management around the time of issuance and the extent to which it can explain the post-issue stock underperformance.

Private placements, together with seasoned public offerings of common equity (SEO), are two important vehicles by which public firms obtain equity financing. Contrary to seasoned public offerings of common equity, which issue new equity to the general public, private placement issuers sell new equity to a restricted number of investors. More than 30 percent of seasoned equity financing from external investors in recent years has come from private placements (Federal Reserve Bulletin, see Appendix A). While there is a sizeable body of literature on earnings management around the time of seasoned public offerings and on the issuers' post-issue stock underperformance, research on these issues related to private placements is scarce.

Studies on earnings management constitute an important research stream in the literature about the quality of earnings. Typical research methodology on earnings management first identifies a firm-specific event around which managers' incentives to engage in opportunistic earnings manipulation appear to be strong, then employs various

accrual models to test the researchers' earnings management hypotheses (Healy and Wahlen 1999). In response to the call of Dechow and Skinner (2000) for further research on earnings management incentives around the time of securities issuance, this study examines, among other things, earnings management around the time of private placement, an important corporate event.

Earnings have been widely used by investors to assess firm value and security offerings provide a direct incentive to manipulate earnings (Dechow and Skinner 2000). Managers of an issuing firm could use the accounting methods allowed under generally accepted accounting principles (GAAP) to inflate reported earnings at the time of the issuance in an attempt to portray a rosy picture of the firm's prospects. To the extent that such income-increasing accounting choices are not detected by investors, managers may obtain more favorable terms when selling new shares, thus gaining direct monetary benefits for themselves and the firm. Existing literature provides an abundance of evidence of earnings management around the time of various types of security issues, particularly initial public offerings (Aharony et al. 1993; Friedlan 1994; Teoh et al. 1998a; DuCharme et al. 2001), seasoned public equity offerings (Teoh et al. 1998b; Rangan 1998), convertible bond issues (Margetis 2004), and stock-for-stock mergers (Erickson and Wang 1999). Since private placement is one of the most important sources of corporate financing, this study predicts that managers of the issuing firms have strong economic incentives to inflate reported earnings around the time securities are issued.

This study finds that managers of U.S. private placement issuers tend to engage in income-increasing earnings management around the time of the issuance. The mean and

median of the discretionary accruals, the proxy for earnings management, of 348 sample firms from 1989 to 2001 are 3.27 percent and 2.49 percent of total assets in the year prior to the issue year. To eliminate the impact of other influencing factors, the study employs a control sample consisting of firms matched on size and leverage in the same industry of the issuing firms. In the year prior to the private placements, the discretionary accruals of the issuing firms significantly exceed their non-issuing peers by 3.99 percent in mean and 1.98 percent in median.

Issuing private placements could be an endogenous choice. To mitigate this self-selection bias, the study also adopts the propensity score matching method to form the control sample. Consistent with those of size and leverage matching, discretionary accruals of issuing firms significantly exceed their non-issuing peers by 4.27 percent in mean and 1.87 percent in median in the year prior to the issuance. This result suggests that the findings on earnings management are not sensitive to alternative matching methods in selecting the control sample.

Among various anomalies in the semi-strong form of the market efficiency hypothesis, private placement has recently been found to be mispriced at the time of the issuance. In particular, Hertz et al. (2002) observe that firms conducting private placements experience negative abnormal stock returns during the post-issue period. They postulate that the reason for the post-issue stock underperformance is that, at the time of the issuance, investors are over-optimistic about the issuing firms' future performance. However, the source of the over-optimism is not identified clearly. Thus, the second purpose of this study is to examine whether earnings management at the time

of private placements serves as a likely source of investor over-optimism. If investors misinterpret the manipulated earnings around the time of private placements, the stock price would be temporarily overvalued. However, when the inflated earnings do not persist in the future and/or the income-increasing accruals made at the time of issuance reverse in the subsequent periods, investors become disappointed and beat down the stock price of the issuing firms. To test this projection, this study proposes that the income-increasing accounting accruals made at the time of private placements predict the post-issue stock underperformance.

To explore the relationship of discretionary accruals at the time of private placement issuance with the post-issue stock performance, the sample is divided into four groups according to the discretionary accruals made in the year prior to the issuing year. The quartile group with the smallest discretionary accruals is called the conservative group and the one with the largest discretionary accruals is called the aggressive group. The study finds that the aggressive group has consistently poorer post-issue stock performance than the conservative group. For example, the three-year post-issue market excess return of the aggressive group lags that of the conservative group by 13.29 percent, and the three-year post-issue abnormal return of the aggressive group lags that of the conservative group by 35.23 percent. This result suggests that firms that inflate their earnings more aggressively around the time of private placements experience poorer stock performance subsequent to the issuance.

The study also runs regressions of the post-issue stock performance on discretionary accruals at the time of private placements, along with control variables such

as size, book to market ratio, and industry dummies. Three-year market excess returns and the abnormal returns of issuing firms are both significantly negatively correlated with the discretionary accruals made in the year prior to the issuance. This evidence supports the hypothesis that the discretionary accruals around the issuance of private placements predict the post-issue stock underperformance. Thus, earnings manipulation around the time of private placements could be a source that causes investors' over-optimism at the time of the issuance.

The final purpose of this study is to investigate whether U.S. managers' opportunistic behavior around private placements and their relationship with the post-issue stock underperformance also occurs in Japan. Fama and French (1998) suggest that researchers should study issues of the same nature using data from countries other than the U.S. to avoid data mining. With the second largest capital market in the world, the Japanese market provides an important out-of-sample pool in which to examine how well the findings in the U.S. market can be generalized.

The study finds that, similar to their U.S. counterparts, Japanese managers also tend to report inflated earnings around the time of private placements issuance. The mean and median of the discretionary accruals of the sample of 274 issuing firms from 1977 to 1999 are 5.82 percent and 3.43 percent of total assets in the year of issuance. The discretionary accruals of issuing firms exceed their non-issuing peers by 6.51 percent in mean and 3.87 percent in median. Using a different matching method, propensity score matching, the discretionary accruals of issuing firms still exceed those of their non-issuing peers by 6.05 percent in mean and 3.78 percent in median.

One important difference observed in the pattern of earnings management between U.S. issuers and Japanese issuers is the timing of earnings management. While managers of U.S. issuers tend to inflate earnings in the year prior to private placements, Japanese managers appear to report inflated earnings in the issuing year. A number of reasons are offered to explain this difference.

For Japanese private placements issuers, the post-issue stock performance shows a strong correlation with discretionary accruals made in the issuing year. Compared with the conservative group in the three-year post-issue period, the buy-and-hold raw return for the aggressive group is 13.09 percent lower, the buy-and-hold market excess return is 11.62 percent lower, and the buy-and-hold abnormal return is 8.21 percent lower. In the five-year post-issue period, the raw return for the aggressive group is 18.96 percent lower, the market excess return is 11.44 percent lower, and the abnormal return is 30.65 percent lower. The parameter of regressions of three-year and five-year post-issue stock raw returns, market excess returns, and abnormal returns on discretionary accruals made in the issue year are statistically significant, suggesting that the earnings management by Japanese private placement issuers in the year of issuance predicts the firm's post-issue stock underperformance.

This study makes a number of contributions to the literature. First, the study adds evidence to the sizeable body of research on earnings management around the time of security issuance by documenting income increasing earnings management around the time of private placements. Therefore, it complements the findings of prior studies on other types of security issuances. Second, the study sheds new light on the capital market

anomaly related to private placements. While existing literature attributes post-issue stock underperformance to investor over-optimism at the time of the private placement, the findings of this study suggest that a possible source of this over-optimism is earnings management around the time the securities are issued. Finally, this study contributes to the earnings management literature in an international context by identifying the pattern of earnings management around the time of private placements and the extent to which it can explain the post-issue stock underperformance in the world's two largest capital markets, the U.S. and Japan.

The rest of the paper is organized as follows. Chapter 2 presents the background literature on private placements and the hypotheses of the study are developed in Chapter 3. Chapter 4 describes the sample and methodology while Chapter 5 presents the primary findings of the study. Sensitivity analyses are conducted in Chapter 6 and Chapter 7 concludes the study.

CHAPTER 2 BACKGROUND AND LITERATURE REVIEW

This chapter presents the background literature for this study. The background literature of public offerings and private placements, the issuing puzzle, and earnings management regarding the public offerings are presented first, followed by discussions of related private placement literature and, finally, the relevant international literature.

2.1 Public Offerings and Private Placements

Public offerings and private placements, focusing on raising equity capital from external investors, are two important ways for public companies to conduct seasoned equity offerings. Both individuals and institutional investors can participate in public offerings, which are usually conducted via a managing investment bank as the underwriter or underwriting syndicate. U.S. companies must register the issue with the Security and Exchange Commission (SEC) when they conduct public offerings.

Companies can avoid this costly process if they conduct equity offerings privately. Private placements refer to the direct issuance of equity securities to a restricted number of investors. Most private placement investors are large institutional investors such as mutual funds and pension funds. The price of the issue is determined by negotiation between the issuer and the investors (Ross et al. 2002; Keown et al. 2003; Marciukaityte 2001).

There are several other advantages to private placements over public offerings. First, the issuers are exempted from the registration and disclosure requirements of various securities statutes. Second, investment dealers' fee for a private placement is much less than that for a public offering. Third, private placements can also help firms

raise capital quickly. Fourth, obtaining private placements significantly improves a firm's ability to attract additional capital, research partners, and commercial partners (Srivastava 1989; Folta and Janney 2004; Janney and Folta 2006).

2.2 Issuing Puzzle

Most studies on seasoned public offerings in the mid-1980s examine the stock market reaction to the issue announcements. These studies generally document a negative market reaction to the announcement of the issuance. On average, the two-day abnormal stock returns on announcement of public offerings are -3.14 percent for industrial companies and -0.75 percent for utility companies (Smith 1986), suggesting that stock price is overvalued when firms conduct public offerings. A theory developed by Myers and Majluf (1984) to explain this negative market reaction argues that managers know a good deal about the company they manage, so when the company's stock price is undervalued, managers will be less likely to issue equity to new investors because it would let them take advantage of existing shareholders. It is more likely that managers decide to issue new equity when the stock price is overvalued, so stock price falls when firms announce the public offerings because it sends a signal to the market that managers believe the company's stock is overvalued.

Loughran and Ritter (1995) conduct the first study to examine the long-run post-issue stock performance of firms that conduct public offerings. They find that after public offerings, firms experience negative abnormal stock returns for up to five years compared to similar size firms in the same industry which do not issue new equity. Spiess and Affleck-Graves (1995) find similar results, so both studies conclude that

managers take advantage of a firm's specific information to issue equity when the firm's stock is overvalued. This explanation was called the *windows of opportunity hypothesis*. Considering the negative market reaction to the announcement of the new issues, the *underreaction hypothesis* is developed to explain the poor post-issue stock performance. The underreaction hypothesis maintains that the stock market reflects only part of the information about the share price when new issues are announced. Daniel et al. (1998) develop a model to explain the underreaction phenomenon from the behavioral theory approach and conclude that investors tend to overestimate their ability to generate information and tend to underestimate their forecast errors.

The phenomenon of poor post-issue stock performance of public offerings has its dissenters. For example, Fama (1998) argues that the documented poor performance is based on the assumption of efficacy of the benchmarks used. Thus, he questions the accuracy of benchmarks and suggests that the phenomenon of poor post-issue stock performance in public offerings is only a random variation of market efficiency. Brav et al. (2000) and Mitchell and Stafford (2000) provide evidence to support Fama's arguments and conclude that, once appropriate benchmarks are used to measure abnormal returns, the magnitude of the anomalies in stock prices subsequent to public offerings substantially decreased. On the other hand, Bayless and Jay (2003) expand the study of Brav et al. (2000) but find that firms making public offerings consistently experience superior performance except during the five years following the issue. Although alternative explanations exist, the poor post-issue stock performance of public offerings is

still widely believed to be an important challenge to the capital market efficiency (Hertzel et al. 2002).

2.3 Earnings Management around Seasoned Public Offerings

Managers have incentives to manipulate earnings by choosing reporting methods and estimates that may not accurately reflect their firms' underlying economics. They may do this for their own benefit or for the existing shareholders' benefit. 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 and Wahlen 1999). Previous studies have identified a variety of earnings management incentives, including capital market expectations and valuation, contracts written in terms of accounting numbers, and government regulations, among others. Dechow and Skinner (2000) propose that, since managers have become increasingly sensitive to their firms' stock price levels and their relationship to earnings, researchers should focus more on capital market incentives for earnings management and in particular, on the strong incentives to beat benchmarks and boost stock prices before issuing equity.

Several studies provide consistent evidence of managers' opportunistic behavior around the time of public offerings. Given the poor post-issue stock performance which shows an average return of only 7 percent per year while returns for matched non-issuing firms average 15 percent per year, it is doubtful why investors buy those issues (Loughran and Ritter 1995). Teoh et al. (1998b) examine whether managers manipulate

reported earnings around the issuance of public offerings and whether earnings management around the time of offerings can lead investors to be overly optimistic about the issuer's prospects, which would explain, at least in part, the poor post issue stock performance. They find that in the issuing year, issuers' asset scaled discretionary current accruals exceed their performance matched industry peers by 2.9 percent. They also find that the discretionary accruals predict the underperformance in the post-issue stock returns. Using different samples, Rangan (1998) has similar results. Shivakumar (2000) provides additional evidence on managers opportunistic behavior around SEOs; however, he argues that earnings management may not be designed to mislead investors; rather, it may reflect managers' rational response to an anticipated negative market reaction to the offering announcement.

2.4 Market Reaction to Private Placement Announcements

Unlike firms making public offerings, firms conducting private placements experience positive market reaction at the announcement of issuance. Wruck (1989) documents a 4.5 percent average abnormal return during the announcement period and Hertz and Smith (1993) report a similar result. However, the two papers differ in their explanations for this phenomenon. First, Wruck proposes an ownership structure hypothesis to interpret her findings, explaining that the higher the level of ownership concentration, the easier it is for a small group of shareholders to influence managers' behavior to align managers' and shareholders' interests. To support this explanation, Wruck finds that the total holdings of those investors reported in proxy statements increase from an average of 31 percent to an average of 37 percent of the firm's voting

shares and the change in firm value at the announcement of a private placement is strongly correlated with the resulting change in ownership concentration. Hertz and Smith, on the other hand, propose the information hypothesis to explain the positive market reaction. Following Myers and Majluf's (1984) assumption, Hertz and Smith conclude that undervalued firms will not likely issue equity publicly to avoid releasing negative signals about the firms' value. In addition, they argue that the willingness of private placement investors to commit funds to the issuers conveys a signal to the market that the issuers are undervalued. To support this hypothesis, they find a correlation between the positive abnormal returns at the announcement time and the potential undervaluation.

2.5 The Monitoring Role of Institutional Investors

The findings of Wruck (1989) and Hertz and Smith (1993) tend to support the view that the involvement of large investors that purchase private placements increases the issuer's value by providing either a monitoring role or a certification role. Many studies document that institutional investors have an effective monitoring effect on management behavior. Shleifer and Vishny (1986) develop a model to prove theoretically that institutional investors can increase the monitoring role and mitigate the free rider problem. McConnell and Servaes (1990) empirically document a significant positive relationship between the value of the firms and the percentage share ownership of institutional investors. Bushee (1998) finds that managers are less likely to myopically cut R&D expenditure to reverse an earnings decline when institutional ownership is high, implying that institutional investors, as sophisticated investors, serve a monitoring role in

curbing the myopic behavior. Chung et al. (2002) provide evidence that the presence of large institutional investors prohibit managers from increasing or decreasing reported profits in their own interest. Rajgopal et al. (2002) show that the absolute value of discretionary accruals declines with institutional ownership, a result consistent with managers' recognition that institutional investors are better informed than individual investors, which reduces the perceived benefit of earnings management. In a review of corporate governance studies, Shleifer and Vishny (1997) conclude that institutional investors in the U.S. reduce agency cost in firms and pressure managers to improve their true economic performance.

If the institutional investors that purchase private placements do enhance the monitoring role and constrain managers' opportunistic behavior, different from the public offerings, we may not find earnings management behavior around the time of private placement issuance. However, recent findings on private placements have suggested that most of those institutional investors involved in private placements are *passive* and that they bring no more of a monitoring role than do investors in public offerings (Barclay et al. 2005; Wu 2004). Therefore, it is still likely that managers engage in earnings management to mislead investors at the time of private placements.

2.6 Recent Findings on Private Placements

Hertzel et al. (2002) find that, along with positive market reaction to the announcements of issuance, public firms conducting private placements experience poor post-issue stock performance, which is not consistent with the underreaction hypothesis drawn from public offering studies. Under the underreaction hypothesis, the positive

announcement effect should cause firms conducting private placements to experience positive abnormal returns in the long run. Hertz et al. conclude that investors are overoptimistic about the prospects of firms that issue equity, publicly and privately. The importance of this finding is that, contrary to the traditional belief, firms conducting private placements are overvalued, possibly because investors are overoptimistic about the monitoring role of new institutional investors.

Recent studies have challenged the anticipated monitoring effect by the involvement of new institutional investors. Larcker et al. (2005) find that fourteen corporate governance factors, including institutional ownership, explain only 0.6 percent to 5.1 percent of the cross-sectional variation of a wide set of dependent variables, including abnormal accruals. This finding suggests that institutional ownership has very limited ability to explain managerial behavior and organizational performance. Barclay et al. (2005) provide evidence that supports the *entrenchment hypothesis*, which proposes that managers consider not only the interests of shareholders but their own interests as well when they conduct private placements. The entrenchment hypothesis also maintains that managers dislike being monitored (Brennan and Franks 1997; Field and Sheehan 2004), and are, therefore, likely to place the equity with passive institutional investors who will not interfere with managerial decisions. Barclay et al. find that, after the issuance, most private placement purchasers remain passive, that firm value declines, and that there are few acquisitions. Wu (2004) examines the monitoring role of managers on the choice between public offerings and private placements and finds that private placement investors do not engage in more monitoring than public offering investors do.

In the absence of the monitoring roles brought by the new institutional investors, managers may act opportunistically when they conduct private placements if there are strong incentives for them to do so.

2.7 International Perspective

Some researchers have expanded the new issue studies to other countries. In Japan, Kang and Stulz (1996) study the market reactions to announcement of various equity issues and convertible debt issues. They find that, similar to the U.S. studies, the abnormal return for the 3-day window surrounding the announcement of private placements is 3.13 percent; however, contrary to the U.S. findings, the abnormal return for public offerings is also positive but small at 0.45 percent. Based on this evidence, Kang et al. (1999) examine the long-term post-issue performance of Japanese firms that issued equity and convertible debt and find that both public offering and private placement issuers underperform for at least five years. Their results contradict the underreaction hypothesis derived from studies using the U.S. data. Cai and Loughran (1998) also study Japanese firms conducting public offerings and also find underperformance over the subsequent five-year period. Mathew (2002) reports similar results for firms conducting public offerings in Japan and Hong Kong; however, firms in Korea have experienced insignificant post-issue abnormal returns, suggesting that the underperformance after public offerings does not always hold in other countries. Tan et al. (2002) find a positive announcement effect for both right offerings and private placements in Singapore, while Wu et al. (2005) provide evidence that the positive announcement effect occurs not only with private placements but also with public

offerings in Hong Kong and suggest that the positive announcement effect may be influenced by factors other than the monitoring effect, which is associated with the changes in ownership concentration.

Several studies have also documented the issuing puzzle in European countries. Levis (1995) finds long-run stock underperformance following public offerings for U.K. firms; similar evidence is reported by Kabir and Poosenboom (2003) for firms in the Netherlands and by Pastor-Llorca and Martin-Ugedo (2004) for Spanish firms. However, Ho (2005) finds no evidence of long-run post-issue underperformance of U.K. firms following public offerings.

Several studies have also investigated managers' opportunistic behavior around equity offerings in countries other than the U.S. Ching et al. (2002) investigate the right offering firms in Hong Kong and find evidence of earnings management around the time of the offering. They also find that right offering firms with larger boards have a higher degree of earnings management. Yoon and Miller (2002) study 249 Korean public offering firms and find that Korean issuers manage earnings, especially when their operating performance has been poor. Reddy (2005) examines Indian firms conducting seasoned public offerings and finds that the discretionary accruals are larger for issuing firms than for non-issuing firms, although the difference is not statistically significant. Beuselinck et al. (2005) study Belgian unlisted firms and find that they manage earnings upward prior to receiving venture capital and that after the involvement of venture capital, the level of earnings management declines; this suggests that the involvement of venture capital induces higher earnings quality. Guan et al. (2005) examine Japanese

firms conducting seasoned public offerings and find that Japanese managers tend to choose not to manage earnings prior to issuing but to defer managing earnings to the post-issue period to hide post-issue poor operating performance. While the empirical results of these studies on earnings management around the time of public offerings are generally consistent with those using the U.S. data, there is little evidence regarding managers' opportunistic behavior around the issuance of private placements in an international setting.

CHAPTER 3 HYPOTHESES DEVELOPMENT

This chapter develops the four hypotheses of the study. First, the earnings management hypotheses for both U.S. and Japanese issues around the issuance of private placements are developed, followed by the hypotheses on the association of earnings management around the time of the issuance and the post-issue stock underperformance for both the U.S. and Japanese issuers.

3.1 Earnings Management around the Issuance of Private Placements

3.1.1 U.S. Issuers

Earnings are among the most important measures investors use to assess a firm's future performance (Healy and Wahlen 1999). Dechow and Skinner (2000) suggest that, around the time of new securities issuance, managers have strong incentives to manipulate earnings to portray a rosy picture of the firm's future performance and, consequently, may sell the securities on more favorable terms and therefore reduce the cost of financing. Empirical evidence on certain types of securities issue appears to support this argument. For example, both the initial public offering issuers (Aharony et al. 1993; Friedlan 1994; Teoh et al. 1998a; DuCharme et al. 2001) and seasoned public equity issuers (Teoh et al. 1998b; Rangan 1998) tend to make income-increasing accounting choices around the time of issuance in an attempt to increase the selling prices of the new equity. In corporate stock for stock mergers, the acquiring firms manage earnings upward in the periods prior to the merger agreement to increase their stock prices in order to reduce the cost of buying the target firms (Erickson and Wang 1999). Unlisted firms also tend to manipulate earnings upward prior to receiving venture capital

financing in order to show a better picture of their company's prospects, thereby increasing the chances of being funded by venture capitalists (Beuselinck et al. 2005). Similarly, firms conducting private placements may also have incentives to report inflated earnings prior to the issuance in order to attract more investors since the manipulated earnings may lead the investors to believe that the reported earnings could continue into the future and therefore become overly optimistic about the issuers' future performance. This would allow private placement issuers to boost their images and sell their new equity on more favorable terms.

It would be pointless for managers to manipulate earnings if private placement purchasers could see through it. However, Healy and Wahlen (1999) argue that investors may not fully see through earnings management that is reflected in accruals; even for underwriters, fully adjusting for accounting choices may be difficult and costly (Friedlan 1994). Since most private placement investors are institutional investors, managers' opportunities to manage earnings around the issuance may be restrained because of the *active* involvement of institutional investors (Chung et al. 2002). However, Barclay et al. (2005) find that managers issuing private placements deliberately select *passive* institutional investors, and Wu (2004) provides evidence showing that private placement investors do not provide more monitoring roles than public investors¹. Therefore, it is likely that private placement issuers still have the opportunity to manipulate earnings around the issuance and that such behavior may go undetected by investors.

Engaging in earnings management at the time of private placement is not without downside risks. First, subsequent discovery of the earnings management around the time

of private placement may lead to lawsuits by investors if the earnings overstatement leads to investor losses (DuCharme et al. 2004). Second, such a discovery will undoubtedly reduce the credibility of the issuing firms' financial statements and impair their ability to raise additional capital at favorable terms in the future. Finally, U.S. firms identified by the Securities and Exchange Commission (SEC) as violators of GAAP will face an increase in their future costs of capital.

Even so, because the economic benefits of reporting inflated earnings prior to private placement are substantial, if managers do not think they are likely to be discovered or if the costs of discovery are perceived less than the potential benefits, they are likely to adopt the discretionary accounting choices that increase the reported earnings around the time of private placement issuance. Therefore, the first hypothesis of the study is:

H₁: Managers of U.S. private placement issuing firms manipulate reported earnings upward around the time of issuance.

3.1.2 Japanese Issuers

Literature documents that Japanese managers and U.S. managers have similar objectives although the corporate governance systems are different. A seminal paper of Kaplan (1994) studies top executive turnover and compensation, and their relation to firm performance in the U.S. and Japanese companies. He finds that, similar to the U.S., Japanese management turnover and compensation are related to earnings and stock returns and the compensation of Japanese managers are positively correlated with stock performance and current cash flow. More importantly, the relations for the Japanese

managers are generally economically and statistically similar to those for their U.S. counterparts. Therefore, Japanese managers are similar to U.S. managers in their focus on current earnings performance.

A number of studies have investigated Japanese managers' opportunistic behavior and provided evidence that, similar to their U.S. counterparts, Japanese managers also engage in earnings management under various scenarios. Thomas et al. (2004) report that, in addition to managing discretionary accruals, Japanese managers also manipulate earnings using transactions with affiliated companies to avoid losses, earnings declines, and negative forecast errors. Hermann et al. (2003) find that Japanese managers use gains from the sale of fixed assets and marketable securities to manage earnings in order to avoid reporting earnings below forecast and the previous year's earnings. Mande et al. (2000) document that Japanese managers make myopic decisions by adjusting their research and development allocations to smooth earnings, while Hermann and Tatsuo (1996) document that Japanese managers use depreciation changes to manage earnings. Agarwal et al. (2005) find that Japanese banks use security gains and loan loss provisions to manage earnings, and Guan et al. (2005) provide evidence that Japanese managers manipulate earnings around public equity offerings.

Other studies have suggested that the degree of earnings management in Japan could be stronger than that in the U.S. Lang et al. (2004) compare the characteristics of earnings for U.S. companies with reconciled earnings for non-U.S. companies cross-listed on the U.S. market and find that Japanese firms belong to higher level of earnings management group than U.S. firms do. Leuz et al. (2003) develop an aggregate measure

of earnings management across countries and show that the earnings management problem is more prevalent in Japan than in the U.S., partly because of weaker investor protection in Japan. The monitoring role of institutional investors, such as pension funds, mutual funds, and insurance companies, has also been found to be weaker in Japan (Gibson 1998).

Therefore, if the economic incentives to report inflated earnings are strong among Japanese private placement issuers, it is likely that managers of the issuing firms will engage in earnings manipulation at the time of issuance. Thus, the second hypothesis of this study is:

H₂: Managers of Japanese private placement issuing firms manipulate reported earnings upward around the time of issuance.

3.2 Earnings Management and Post-Issue Stock Underperformance

Hertzel et al. (2002) recently pinpoint the long-term stock underperformance subsequent to private placements. Relative to control firms matched by size and book to market ratio, the mean three-year buy and hold abnormal return is -23.8 percent, which is similar to that found for initial public offerings and seasoned public equity offerings. Hertzel et al. argue that the post-issue stock underperformance is likely due to the investors' over-optimism about the issuers' future performance around the time of private placements, although they do not identify clearly the source of the over-optimism.

This study proposes that earnings management around the time of the issuance of private placements is a likely source of investor over-optimism. If investors expect the reported (but manipulated) earnings around the time of private placements to persist into

the future, stock price will be temporarily overvalued. Then, when the income-increasing accruals reverse in subsequent periods and the earnings trend does not persist, investors may become disappointed and beat down the stock price. Thus, if earnings management at the time of issuance is a source of investor over-optimism, the aggressive accounting accruals at the time of the private placement issuance will cause post-issue stock underperformance. Several studies examining seasoned public offerings have made a similar prediction and found evidence supporting this prediction. For example, Teoh et al. (1998b) and Rangan (1998) find that earnings management around the issuance of seasoned public offerings explains a portion of the post-issue stock underperformance. Specifically, the higher the discretionary accruals around the issuance of seasoned public offerings, the lower the abnormal post-issue stock returns. Following this line of reasoning, the third and fourth hypotheses are:

H₃: Earnings management around the time of private placements conducted by U.S. issuers predicts post-issue stock underperformance.

H₄: Earnings management around the time of private placements conducted by Japanese issuers predicts post-issue stock underperformance.

CHAPTER 4 SAMPLE AND METHODOLOGY

This chapter first discusses the sample selection for both U.S. and Japanese private placement issuers, followed by descriptions of the methodology of the study. The last part of this chapter addresses the methods used to test the hypotheses.

4.1 Sample

The initial U.S. sample of private placement issues is obtained from the *New Issues Database* from Securities Data Corporation. The issuers' financial data are obtained from Standard and Poor's *Research Insight* database, and stock returns from the Center for Research in Security Prices (*CRSP*). The *New Issues Database* contains 831 private placement common stock issues from 1989 to 2001 in the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the NASDAQ. To qualify for the study sample, firms issuing private placements must have the necessary financial data to allow a calculation of discretionary accruals in the year prior to the issue, matching measurements, and stock returns for at least one month after the issue. Financial and utility firms are eliminated from the sample because these firms are subject to special regulations. In order to reduce the confounding effects on earnings management from public equity offerings, firms conducting both public offerings and private placements in the same year are also excluded from the sample. If firms issued multiple private placements within three years, only the first issue is kept in the final sample.

The final U.S. sample contains 348 observations. Table 1 presents the sample size and gross proceeds by year and industry classification for the U.S. private

placements issues. Because the study adopts the cash flow approach to calculate discretionary accruals for the U.S. firms, the sample starts from the year 1989.² The study also needs to test the stock performance five years after the issuance, so sample data ends in the year 2001. Four years (1992, 1993, 2000, and 2001) are very active and contain more than 25 issues each year. Chemical products, instruments and related products, and service industries each carry more than 10 percent of the sample.

[Insert Table 1 about here]

The initial sample of Japanese private placement issues is obtained from the *NEEDS* Corporate Action Related Database, compiled by Nihon Keizai Shimbun Inc. The issuer's financial and stock return data are obtained from the Pacific-Basin Capital Markets (*PACAP*) database. The *NEEDS* database provides 542 private placement issues from 1977 to 1999. Similar to the U.S. issues, to be included in the sample, firms issuing private placements must have the necessary financial data to allow calculation of discretionary accruals in the year prior to the issue, matching measurements, and at least one month's stock returns after the issue; financial and utility firms are eliminated from the sample, as are issuers that conduct private placements and public offerings at the same time. If a firm conducts more than one private placement within a three-year period, only the first issue will be included in the sample. The final Japan sample consists of 274 issues. Table 2 reports the statistics of the sample. Two years (1977 and 1999) are very active, and each contains more than 10 percent of the sample. Machinery and electric machinery industries each contain more than 13 percent of the sample.

[Insert Table 2 about here]

4.2 Methodology

4.2.1 Timing of Earnings Management

Identifying of the timing of earnings management *a priori* is critical in any earnings management study. In keeping with the earnings management research on IPOs and SEOs, a company's annual financial statements are defined as being for the issuing year (year 0) if the fiscal year-end of the financial statements is within 12 months after the private placement date. Based on this definition, it is possible that the annual financial statements of an issuing firm for year 0 will cover some months prior to the private placement date because the fiscal year-end can be less than 12 months after the private placement date. Once year 0 is defined, financial statements for other years surrounding the private placement date (i.e., year -2, -1, +1 and +2) can be defined accordingly.

Extant earnings management literature on IPOs and SEOs documents that earnings management is most prominent in the year preceding the issuing year (year -1) and/or the year of the issuing year (year 0). Several studies (Friedlan 1994; Aharony et al. 1993; DuCharme et al. 2000) have examined earnings management prior to making IPOs and find that IPO firms tend to inflate earnings in the year prior to the IPO (year -1). Teoh et al. (1998a) define the issue year (year 0) as the fiscal year in which the IPO occurs (which is the same definition this study uses) and includes both pre- and post-IPO months, arguing that IPO firms have incentive to manipulate both pre- and immediate post-IPO earnings. Teoh et al. (1998b) study earnings manipulation around the issue of SEOs and find that discretionary current accruals for SEO firms are positive in year -1 and more prominent in year 0.

While the same arguments about earnings management for IPOs and SEOs can be made for private placements, the relative strength of these arguments and the effects of some other factors also need to be considered in determining the timing of earnings management by private placement issuers:

- (1) Most IPO and SEO studies maintain that earnings management made in year -1 helps to inflate stock prices and to increase the proceeds from the issuance.
- (2) Since the reverse of accruals made in earlier years increases the litigation risk for the issuers, managers have incentives to continue to manage earnings upward after issuing securities.
- (3) Prior to issuing securities, firms have strong incentive to release optimistic earnings forecasts and to announce good news in order to boost the stock price or investors' confidence. Ruland et al. (1990) find that firms issuing earnings forecasts are more likely to finance externally in the subsequent three months than are the control firms that did not issue earnings forecasts. Frankel et al. (1995) also find that firms are more likely disclose earnings forecasts if they plan to raise capital. When managers conduct voluntary disclosures, they tend to disclose information favoring them or existing shareholders. For example, Aboody and Kasznik (2000) find that CEOs opportunistically manage the timing of their information disclosures to increase the value of their stock option awards by delaying announcements of good news and rushing forward bad news before the awards. Again, to reduce the risk of litigation or to increase the credibility of managers' voluntary disclosures, the issuing firms have incentive to inflate

earnings in the annual reports that cover the time period when the earnings forecasts and good news are released.

- (4) The ability of managers to boost earnings in consecutive years is limited by a number of factors. First, the current accrual accounting system provides a limited set of methods by which to manipulate earnings (Watts and Zimmerman 1986). Second, since the balance sheet accumulates the effect of previous accounting choices, managers' ability to manipulate earnings decreases with how much net asset values have been already overstated on the balance sheet (Barton and Simko 2002).
- (5) Since all accruals will reverse in the future, the external auditor bears a higher risk of litigation if income-increasing earnings management occurs in consecutive years. Therefore, if earnings management occurs in one year, the external auditor has incentive to curtail earnings management in the following year.
- (6) The issuing firms may also face litigation and reputation damage if a large amount of earnings management is detected by the investors, although the risk of investor litigation is lower in Japan than in the U.S. (Leuz et al. 2003).
- (7) Since private placement buyers are mostly institutional investors, the ability of these investors, even though passive, to initiate lawsuits against the issuer, if earnings management is detected, is likely to be greater than the ability of investors in IPOs or SEOs to do so. This is because the free-rider problem is less severe among the private placement buyers.

Thus, the timing and extent of earnings management around the time of private placements are an *empirical* issue. It is possible that the issuers manage earnings upward in both year -1 and year 0, while it is also possible that the issuers manage earnings upward only in year -1 and not in year 0, or vice versa, and that the timing of earnings management may be different between U.S. issuers and Japanese issuers. Since this study examines the discretionary accruals in each of the five years surrounding the issuing year, the timing and extent of the earnings management made by U.S. issuing firms and Japanese issuing firms will likely be captured by this time span.

4.2.2 Proxy for Earnings Management

If earnings management has occurred, it is likely that there is evidence in measures that reflect accounting policy choices. It would be informative not only to find evidence of earnings management, but also to identify the accounting choice or choices that have been employed to achieve the desired earnings. However, since most accounting choices are not observed by outsiders, researchers rely on various aggregate measures of earnings management, assuming that methods used by managers to manipulate earnings would be spread over a portfolio of accounting choices. Most recent studies on earnings management have used estimations of discretionary accruals as a measure of earnings management, so this study will adopt the same measurement as the proxy for earnings management.

Dechow et al. (1995) assess the relative performance of five alternative discretionary accrual models for detecting earnings management and conclude that a modified version of the Jones (1991) model provides the most powerful tests of earnings

management. Further, Subramanyam (1996) finds that the cross-sectional variation of modified Jones (1991) model provides better estimates of the normal accruals than the times-series model does. Bartov et al. (2000) find that the cross-sectional modified Jones model outperforms the time-series modified Jones model in identifying firms with qualified audit opinions. Therefore, this study will adopt the modified Jones (1991) model and the cross-sectional estimation method to measure discretionary accruals. Also, since firms' past performances could also affect the level of their accruals (Kathori et al. 2005), the lagged return on assets (ROA) is also included in the regressions to estimate nondiscretionary accruals for each firm.

For U.S. firms, total accruals are measured using the cash flow approach:

$$TA_t = [NI_t - CFO_t] / A_{t-1} \quad (1)$$

where:

TA_t = total accruals
 NI_t = income before extraordinary items and discontinued operations
 (Research Insight data item #123)
 CFO_t = cash flow from operations (Research Insight data item #308 minus data item #124)

For Japanese firms, because information about cash flow from operations is not available³, the balance sheet approach is used to calculate total accruals. Total accruals (TA) are measured as the change in non-cash working capital (excluding current

maturities of long-term debt) less total depreciation expense for the current period in year t , scaled by total assets at the end of year $t-1$; that is,

$$TA_t = [(\Delta CA_t - \Delta CASH_t) - (\Delta CL_t - \Delta CMLTD_t) - DEP_t] / A_{t-1} \quad (2)$$

where:

TA_t	= total accruals in year t
ΔCA_t	= change in current assets in year t
$\Delta CASH_t$	= change in cash in year t
ΔCL_t	= change in current liabilities in year t
$\Delta CMLTD_t$	= change in current portion of long-term debt in year t
DEP_t	= depreciation and amortization expense in year t
A_{t-1}	= total assets at the end of year $t-1$.

To calculate the discretionary accruals, the non-discretionary portion of total accruals must be estimated. For both countries, the expected nondiscretionary accruals for firm i in year t (NDA_{it}) are measured as:

$$NDA_{it} = \beta_{0it}(1/A_{it-1}) + \beta_{1it} (\Delta REV_{it} / A_{it-1} - \Delta REC_{it} / A_{it-1}) + \beta_{2it} (PPE_{it} / A_{it-1}) + \beta_{3it} (ROA_{t-1}) \quad (3)$$

where:

ΔREV_{it}	= change in revenue for firm i in year t
ΔREC_{it}	= change in net receivables for firm i in year t
PPE_{it}	= gross property, plant, and equipment for firm i at the end of year t
ROA_{t-1}	= Return on average assets in year $t-1$
$\beta_{0it}, \beta_{1it}, \beta_{2it}, \beta_{3it}$	= firm-specific parameters for firm i in year t .

In equation (3), the firm-specific parameters, β_{0it} , β_{1it} , β_{2it} and β_{3it} , are estimated cross-sectionally using the two-digit SIC code for firm j 's data ($j \neq i$):⁴

$$TA_{jt} = \beta_{0it} (1/ A_{jt-1}) + \beta_{1it} (\Delta REV_{jt} / A_{jt-1}) + \beta_{2it} (PPE_{jt} / A_{jt-1}) + \beta_{3it} (ROA_{t-1}) + \varepsilon_{jt} \quad (4)$$

Once the nondiscretionary accruals are estimated, the discretionary accruals for firm i in year t (DA_{it}) are calculated as the prediction error:

$$DA_{it} = TA_{it} - NDA_{it} \quad (5)$$

Managers of issuing firms may have managed earnings for reasons other than trying to induce investor optimism. Two prominent reasons relate to firms' desire to reduce the political cost and the debt default cost (Watt and Zimmerman, 1986). Empirically, a firm's political cost is usually proxied by firm size, and debt default cost is proxied by the leverage of the firm. To mitigate the impact of these two factors on the measurement of earnings management, this study employs a matched control sample of non-issuers. If the discretionary accruals of the issuing firms are significantly different from those of the non-issuing control firms in year t ,⁵ then there is evidence of earnings management among the issuing firms in year t and the results of earnings management of the issuers are not likely due to incentives other than inducing investors to accept terms more favorable to the issuers.

For the matching procedure, one control firm is selected for each private placement firm by matching the two-digit SIC code, total assets, and debt-to-asset ratio at the end of year -1 . The control firm should not have conducted private placements in the following three years. Because there are two continuous variables in the matching, this study employs the procedure proposed by Murray (1983). Thus, for each potential matched firm, the Mahalanobis distance is calculated as:

$$D^2 = (\mathbf{M}_b - \mathbf{M}_c)' \mathbf{W}^{-1} (\mathbf{M}_b - \mathbf{M}_c), \quad (6)$$

where:

- D^2 = the distance measure of firm b from private placement firm c,
- \mathbf{M}_b = a vector of matching variables for firm b,
- \mathbf{M}_c = a vector of matching variables for private placement firm c,
- \mathbf{W} = the covariance matrix of the cross-section of matching variables.

D^2 is considered as a univariate measure of multidimensional differences and is calculated for all non-issuing firms within the same two-digit SIC code as the issuing firm. The control firm is the one that has the smallest D^2 . The Mahalanobis distance approach provides a more precise matching measurement than the Euclidean distance approach in that it considers the variance and covariance of each matching variable (Murray 1983).

4.2.3 Measures of Post-Issue Stock Performance

Three measures of stock performance are used in this study: raw return, market excess return, and abnormal return. All the measures are the buy-and-hold returns over a three- or five-year period. The raw returns and market excess returns do not adjust for firms' risk and, therefore, are biased estimates of stock performance. The purpose of including these two measures is so they can serve as benchmarks for the abnormal returns.

The method used to calculate the abnormal returns is similar to Hertz et al. (2002). Specifically, the abnormal return of an issuing firm is calculated as the difference between the buy-and-hold raw return of the issuer and that of a matched non-issuer. Finding the correct matching firm is critical in this process because measures of long-term abnormal stock returns could be subject to greater measurement errors than measures of short-term returns (Kothari and Warner 1997). Barber and Lyon (1997) analyze the empirical power and specification of test statistics in event studies designed to investigate long-run abnormal stock performance and conclude that the control firm approach, in which sample firms are matched by similar size and book to market ratios of

industry peers, yields well specified test statistics. The matching procedure in this study will employ the Mahalanobis distance approach using two continuous variables—firm size and book to market ratio—for a firm within the same two-digit SIC code as the issuer. The firm with smallest D^2 in the same two-digit SIC code is the control firm for the issuer.

4.2.4 Test of Hypotheses

With the issuing year defined as year 0, discretionary accruals of issuing firms in years -2, -1, 0, +1, +2 are calculated. The most important measures used to test Hypotheses 1 and 2 are discretionary accruals in years -1 and 0, since discretionary accruals for other years are not expected to be significantly different from zero. A statistically significant positive measure of discretionary accruals in either year -1 or year 0 (or both) will lend support to Hypotheses 1 and 2.

Testing Hypotheses 3 and 4 involves two steps. In the first step, four portfolios of issuers are formed based on the quartiles of discretionary accruals around the issue year; the discretionary accruals for the year that are significantly positive are used to form the portfolios, and the two extreme portfolios are called the aggressive (quartile 4) and the conservative (quartile 1) private placement issuers. The abnormal returns for each portfolio are calculated as the cumulative buy-and-hold return on sample firms less the simple cumulative buy-and-hold return on control firms over the five-year post-issue period. Hypotheses 3 and 4 predict that the most aggressive issuers will exhibit the most negative post-issue abnormal returns and that the most conservative issuers will exhibit the least negative (in terms of magnitude) post-issue abnormal returns. This first step

provides a view of the relationship between the earnings management around the time of private placements and the post-issue stock performance.

Building on the results of the first step, the second step is a formal statistical test of Hypotheses 3 and 4. Specifically, OLS regressions are run using individual issuer's three- and five-year post-issue raw return, market access return, and abnormal return as the dependent variable. The independent variable of primary interest to the study is the abnormal accruals for year -1 or year 0 , whichever is significantly positive. The regressions also include an industry dummy, firm size, and book to market variables as control variables. The industry dummy accounts for post-issue stock performance across industries and firm size and book to market variables control for firm characteristics. A significantly negative estimate of the coefficient of the discretionary accruals variable will lend support to Hypotheses 3 and 4. The two steps used to test the association between discretionary accruals and post-issue stock performance are similar to those in Teoh et al. (1998b).

The OLS regression model is specified as:

$$R_i = \beta_0 + \beta_1 (DA_i) + \beta_2 (Size_i) + \beta_3 (BtoM_i) + \sum \gamma (Industry_dummies_i) + \varepsilon_i \quad (7)$$

where:

R_i = issuer's raw return, market excess return, or abnormal return

DA_i = issuer's discretionary accruals around issuance

$Size_i$ = issuer's market value of equity

$BtoM_i$ = book to market ratio

$Industry_dummies_i$ = industry dummy variables

CHAPTER 5 EMPIRICAL RESULTS

This chapter first presents the results of the test on earnings managements around the issuance of private placements, beginning with the findings on U.S. private placements issues, followed by those on Japanese issues. Then the correlation between earnings managements and post issue stock underperformance are addressed for both U.S. and Japanese issuers. The final section compares and contrasts the results of U.S. and Japanese issuers.

5.1 Earnings Management around the Issuance of Private Placements

This section presents the evidence of earnings management behavior around the issuance of private placements for both U.S. and Japanese issuers.

5.1.1 U.S. Findings

Table 3 reports five years of asset-scaled discretionary accruals around the issue of private placements for the U.S. issuers and those for the control firms. Figure 1 depicts the mean of discretionary accruals for the U.S. issuers and the control firms over the same period. The mean and median for year -2 are not significantly different from zero; but for year -1, the year prior to the private placements, the discretionary accruals of the issuing firms have a mean of 3.27 percent and a median of 2.49 percent of total assets, both of which are significantly positive. For years 0, +1, and +2, the means and medians are greater than zero; however, they are not statistically significant at the

conventional levels (except for the median for year +1, which is significant at ten percent level).

[Insert Table 3]

[Insert Figure 1]

Since managers' incentives to manage earnings could also be due to firm size and leverage, the results from the modified Jones model should be compared with those of the control group to draw an overall inference about earnings management around the time of private placements. Table 3 also reports the mean and median for those control firms over the same time period, none of which is significantly different from zero. The study conducts pair-wise comparison tests on the differences in discretionary accruals between private placement issuers and their control firms, and the result shows that in the year -1, private placement issuers have significantly greater discretionary accruals in both mean and median than their non-issue peers⁶, suggesting that the observed abnormally high magnitude of earnings managements in year -1 cannot be attributed to firm size, leverage or the industry-specific categories of the sample. The comparison of the mean and median of discretionary accruals between the issuing firms and the control firms does not reveal any statistically significant difference in other years. Thus, the empirical results support the first hypothesis that U.S. managers tend to manipulate earnings upward in the year prior to the issue of private placements.

5.1.2 Japanese Findings

Table 4 reports the five-year discretionary accruals around private placement issues for Japanese issuers and those for the control firms. For year -2, the mean and the

median of discretionary accruals are not significantly different from zero; however, for the year -1, both the mean and the median of issuing firms' discretionary accruals are significantly less than zero. Still, they are not significantly different from their control firms, suggesting that the statistical significance from the discretionary accrual measurement may be caused by factors other than incentives from private placement issues. For year 0, the discretionary accruals for issuing firms have a mean of 5.82 percent and a median of 3.43 percent of total assets, and both are significantly positive. Meanwhile, the mean and median are significantly higher than those for the control firms. Thus, the earnings management for Japanese issuers appears to be concentrated in the year of the issue. For the year +1 and +2, the mean and median are not significantly different from zero and not significantly different from those for the control firms. Thus, the evidence shows that the level of earnings manipulation in the issue year is significantly positive, which supports the second hypothesis.

[Insert Table 4 about here]

[Insert Figure 2 about here]

5.2 Earnings Management and Post-issue Stock Performance

This section discusses the relationship between earnings management around the issue of private placements and the post-issue stock performance. The findings for U.S. issuers are discussed first, followed by those for Japanese issuers.

5.2.1 U.S. Findings

Existing literature documents that after issuing private placements, firms experience negative abnormal stock performance (Hertzel et al., 2002). This study

examines the sample firms and finds results consistent with existing literature. The average three-year buy-and-hold abnormal stock returns for the U.S. sample are -32.83 percent, while five-year abnormal returns are -35.09 percent. The existing literature has postulated that the negative abnormal stock return is due to investors' over-optimism about these issuing firms' future performance. This study argues that earnings management around the private placement issue could be a factor in the investors' over-optimism, because the inflated earnings around the issuance could mislead investors about the issuer's future performance. The reversal of accruals in the following years results in a drop in the issuer's stock price. Thus, the more earnings management, the poorer the post-issue stock performance.

To test this hypothesis, the study first classifies the U.S. issuing firms according to the level of their discretionary accruals in year -1 to derive four portfolios. The quartile group with the lowest discretionary accruals is called the conservative group, and the group with the highest discretionary accruals is called the aggressive group. Buy-and-hold raw returns are developed for each portfolio, and the portfolio is rebalanced every year. Market excess returns for each portfolio are also calculated. In addition, the study adopts the Mahalanobis distance approach to develop a control firm for each sample firm with a similar size and book to market ratio in the same industry. The buy-and-hold excess returns over their control firms for each portfolio are also developed as abnormal returns.

Table 5 reports the raw returns, the market excess returns, and the abnormal returns for the conservative and aggressive portfolio for each year over a five-year post-

issue period. Over the five-year period, the conservative portfolio generates 60.08 percent in raw returns while the aggressive portfolio generates 66.95 percent in raw returns. The market excess returns for the conservative portfolio over the five-year period are 3.81 percent and they are 5.08 percent for the aggressive portfolio. The abnormal returns for the conservative portfolio over the period are -12.82 percent and they are -40.82 percent for the aggressive portfolio. The three-year returns show a similar pattern: the three-year raw return of the conservative group is 18.22 percent and that of the aggressive group is 16.78 percent; the three-year market excess return of the conservative group is 3.54 percent and that of the aggressive group is -9.75 percent; and the three-year abnormal return of the conservative group is -15.98 percent and that of the aggressive group is -51.21 percent. Figure 3 depicts the size and book-to-market value adjusted abnormal returns for each quartile, showing that the aggressive quartile performs more poorly than the conservative quartile and suggesting that the higher the level of discretionary accruals prior to the private placement issuance, the poorer the post-issue stock performance.

[Insert Table 5 about here]

[Insert Figure 3 about here]

The study runs OLS regressions of three-year and five-year post-issue stock raw returns, market excess returns, and abnormal returns on discretionary accruals for year -1, as well as on the control variables of market value, book-to-market, and industry dummies. The regression is run at the firm level, and Table 6 reports the regression results. The variable of most interest is the discretionary accruals in year -1. The

coefficient of the discretionary accruals in year -1 on the three-year market excess returns is -0.3485 and significant at the 5% level ($t = -1.96$); the coefficient of discretionary accruals in year -1 on the three-year abnormal returns is -0.4343 and also significant at the 5% level ($t = -1.83$).

[Insert Table 6 about here]

Thus, the results in table 6 support the third hypothesis. For private placement issuers in the U.S., the higher the discretionary accruals in year -1, the poorer the three-year post-issue market excess returns and abnormal returns. Therefore, the level of earnings management is associated with the three-year post issue stock underperformance, suggesting that earnings management could be a factor causing U.S. investors' over optimism prior to the issue of private placements.

5.2.2 Japanese Findings

Consistent with existing literature, the Japanese issuers of private placements experience poor post-issue stock performance. The average three-year abnormal return for the whole sample is -24.60 percent and the five-year abnormal return is -29.18 percent. Similar to the analysis of the U.S. sample, the Japanese sample is also divided into four groups based on the amount of discretionary accruals in year 0. Table 7 reports the results of the post-issue stock returns for the two extreme groups. The three-year buy-and-hold returns of the conservative group are consistently greater than those of the aggressive group; the three-year raw return of the conservative group is 20.38 percent and that of the aggressive group is 7.29 percent; the three-year market excess return of the conservative group is -7.66 percent and that of the aggressive group is -19.28 percent;

and the three-year abnormal return of the conservative group is -20.33 percent and that of the aggressive group is -28.54 percent. The five-year buy-and-hold returns show a similar pattern: the five-year raw return of the conservative group is 51.39 percent and that of the aggressive group is 32.43 percent; the five-year market excess return of the conservative group is -13.14 percent and that of the aggressive group is -24.58 percent; and the five-year abnormal return of the conservative group is -17.12 percent and that of the aggressive group is -47.77 percent. Figure 4 depicts sixty monthly buy-and-hold abnormal returns for the four portfolios after the issue of private placements and shows that the aggressive group almost always experiences poorer abnormal post-issue stock returns than the conservative group. The findings provide evidence that the poor post-issue stock performance among the Japanese firms is associated with the level of earnings management in the year of the private placement.

[Insert Table 7 about here]

[Insert Figure 4 about here]

Table 8 reports the results of the regressions of post-issue stock returns on discretionary accruals in the year private placement are issued. The results show that three-year post-issue buy-and-hold returns are significantly associated with discretionary accruals in year 0: the coefficient of discretionary accruals in year 0 on three-year raw returns is -0.8679 with $t = -2.16$; the coefficient of discretionary accruals in year 0 on three-year market excess returns is -0.4292 with $t = -1.98$; and the coefficient of discretionary accruals in year 0 on three-year abnormal returns is -0.4302 with $t = -1.36$.

[Insert Table 8 about here]

The five-year post-issue buy-and-hold stock returns are also statistically associated with discretionary accruals in year 0: the coefficient of discretionary accruals in year 0 on five-year raw returns is -1.1033 with $t = -1.89$; the coefficient of discretionary accruals in year 0 on five-year market excess returns is -0.3199 with $t = -1.30$; and the coefficient of discretionary accruals in year 0 on five-year abnormal returns is -0.6425 with $t = -1.58$.

The findings on Japanese private placement issuers, then, consistently support the fourth hypothesis that earnings management around the private placements predicts post-issue stock underperformance. The higher discretionary accruals are in the issue year, the poorer the post-issue stock performance.

5.3 Comparison between U.S. and Japanese Issuers

The analyses provide consistent evidence that, similar to firms issuing IPOs or SEOs, both U.S. and Japanese issuers tend to inflate their earnings around the time of private placements. The manipulated earnings could lead investors to believe that the reported earnings may last into the future and, therefore, to become over optimistic about the issuers' future performance. Such over confidence would allow the issuers to boost their stock prices and sell the new equity under more favorable terms.

The study also provides evidence that the earnings manipulation around the issuance of private placements predicts the post-issue stock underperformance for both U.S. and Japanese issuers. Investors are temporarily fooled by the inflated earnings around private placements and are subsequently disappointed by poor earnings performance when manipulated accruals reverse. The higher the level of manipulated

earnings around the issue of private placements, the poorer the post-issue stock performance.

There are some notable differences in the timing of earnings management between U.S. and Japanese issuers. Managers of U.S. issuers tend to manipulate earnings in the year prior to the issuance, while Japanese managers tend to manipulate earnings in the year they issue the private placements. The discretionary accruals for U.S. issuers in year -1 and 0 are, on average, positive, but the means and medians of discretionary accruals are significantly different from zero only in year -1 . Existing studies have documented that U.S. equity issuers may become the target of legal action when they manipulate their earnings (DuCharme et al. 2004). Thus, managers issuing private placements are likely to choose to manipulate earnings in the year prior to the issue, rather than immediately before the issue in the issue year. This litigation avoidance behavior is also found in Frankel et al. (1995) who find that forces such as legal liability deter managers from more frequent forecasting around the time of an actual equity offering, even though the tendency to issue management forecasts and to finance externally are positively associated over a long period of time.

Japanese managers tend to manipulate their earnings in the issue year. Among the five years around the issue of private placements, only in the issue year (year 0) are the discretionary accruals significantly greater than zero. Contrary to their U.S. counterparts, who have strong incentive to minimize the risk of litigation, Japanese firms seem to be less hesitant to manipulate their earnings immediately around the issue of private placements.

Existing literature points out that investor protection is weaker in Japan (see La Porta et al. 2000 and Leuz et al. 2003), so managers could choose to manipulate their earnings immediately before the issue of private placements without worrying about the litigation risk. One way to manipulate investors' expectations about a firm's future performance is to voluntarily disclose the (inflated) earnings forecast before the issue of private placements.⁷ Consequently, issuing firms are more likely to make income increasing accounting decisions to meet these earnings predictions when they prepare financial statements at the end of issue year (Kasznik 1999).⁸

Another way to mislead investors when private placements are issued is to manipulate interim earnings if the issuer reports interim financial statements prior to the issuance. Japanese publicly traded firms are required to report semiannual interim financial statements and annual statements. Fearing loss of reputation, managers are less likely to let these manipulated interim earnings reverse immediately after a semiannual report, so the manipulated semiannual interim earnings are likely to be reflected on the annual earnings in the issue year.

Another difference between U.S. and Japanese issuers is that earnings management around the time of private placements for Japanese issuers predicts a longer post-issue stock underperformance. Both three-year and five-year post-issue stock returns are significantly negatively associated with discretionary accruals in year 0 for Japanese issuers, whereas only three-year stock returns are significantly associated with discretionary accruals in year -1 and combined discretionary accruals for U.S. firms.

This phenomenon shows that the influence on U.S. firms' long-term stock performance might be more complicated.

CHAPTER 6 SENSITIVITY ANALYSIS

The selection of control firms is crucial in many empirical studies. To test the first and second hypotheses, a control firm for each private placement-issuing firm is chosen to mitigate the influence of factors such as industry, size, and leverage. The discretionary accruals of private placement firms are significantly greater than those of control firms, so the detected earnings management is not due to factors other than the private placement. To test the third and fourth hypotheses, control firms are also developed for the calculation of the issuers' post-issue abnormal returns. Compared to raw returns and market excess returns, abnormal returns are a more accurate measure of stock performance in that they mitigate some systematic and firm specific factors that can influence the stock returns.

Empirical studies have used a variety of matching methods to derive the control firms. When two or more continuous variables are used in the matching, many studies have adopted the Euclidean distance approach and have chosen the firm with the closest Euclidean distance to the experimental firm as its control firm. Murray (1983) is the first to apply the Mahalanobis distance approach to accounting and finance empirical research. The Mahalanobis distance approach, as used in this study, improves the Euclidean distance approach by considering the variance and covariance of these control variables when calculating the distance and, thus, provides more accurate matching. However, the application of the Mahalanobis distance approach is seldom used in accounting and finance studies.

An alternative matching approach, the propensity score matching approach that structures non-experimental data to look like experimental data, has gained popularity in economics research in recent years. Rosenbaum and Rubin (1983) advocate the use of propensity scores, which measure the probability that firms receive treatment, to reduce the dimensionality of the matching. By matching on the scalar variable, sample firms could be matched with the nearest non-treated firms having a similar treatment condition on covariates. Since the propensity score matching method is a significant improvement in matching techniques, it becomes a rapid growing method in accounting and corporate finance as a sensitivity analysis to address self-selection issues (Li and Prabhala 2007).

The sensitivity analysis conducted in this study uses of the propensity score matching method to select the control sample. A logistic regression is processed to calculate propensity scores for the sample firms and the potential control firms. Following existing literature, the independent variables include trading system, industry, issue year, firm size, leverage, book to market ratio, sales, return on assets, and research and development expenses (Spiess and Affleck-Graves 1995, Schultz 2003, McLaughlin et al. 1996, Loughran and Ritter 1997, and Jung et al. 1996). The propensity scores, the probability that a firm may conduct private placements, are derived after the regression. The logistic regression results are shown in Table 9. Due to lack of research and development expense data for Japanese firms, Japanese model does not include this variable.

[Insert Table 9 about here]

Overall, the logistic model for U.S. firms reports a 70 percent accuracy for the issuing firms and a 75 percent accuracy for non-issuing firms, while the logistic model for Japanese firms reports a 76 percent accuracy for the issuing firms and a 77 percent accuracy for non-issuing firms. To be qualified into the pool of non-issuing firms, a firm must have necessary data to calculate discretionary accruals and stock returns. Once the propensity score is calculated for each firm, the control sample can be derived. A non-issuing firm with the nearest neighbor of propensity score in the same industry is chosen as the control firm for each issuing firm.

The annual discretionary accruals for the five-year period surrounding the issue year are calculated for the control firm for each U.S. private placement issuer. Table 10 reports the five year discretionary accruals for the issuers and their control firms. Similar to the results from using the Mahalanobis distance matching to select the control sample, the mean and median of discretionary accruals in year -1 of the sample firms are both significantly greater than those of their control firms⁹. There is no significant difference in discretionary accruals between the issuing firms and control firms for years -2 , 0 , and $+1$. Although year $+2$'s the mean of discretionary accruals for sample firms is significantly and marginally greater than that for the control firms, the median is not significantly different between the two groups. Thus, the results are consistent with the Mahalanobis distance approach, suggesting that the empirical results in Chapter 5 in support of the first hypothesis are not sensitive to alternative matching procedures in selecting the control sample.

[Insert Table 10 about here]

Raw returns are derived for the control firms and five years post-issue abnormal returns are developed as buy-and-hold excess returns over these control firms. Table 11 reports the results of the regression of post-issue stock performance on discretionary accruals for year -1 .¹⁰ The coefficient of discretionary accruals in year -1 on three-year abnormal returns is -0.5082 and is significant at the 10 percent level. The results are qualitatively the same as those from the Mahalanobis distance approach in selecting the control sample, suggesting that the findings on the association between post-issue stock performance and earnings management around the time of private placements are not sensitive to alternative matching methods.

[Insert Table 11 about here]

The sensitivity analysis also provides results similar to the Mahalanobis distance approach for Japanese firms. Table 12 reports the discretionary accruals for Japanese issuing firms, their control firms, and the difference. The discretionary accruals in year 0 for the issuing firms are significantly greater than those for their control firms at the 1 percent level, providing consistent evidence that Japanese issuers manipulate their earnings when they issue private placements. Interestingly, both the mean and median of discretionary accruals in year -1 for issuing firms are significantly (although marginally) less than those for their control firms, suggesting that Japanese managers may reserve some of the accruals before they conduct private placements in order to facilitate the manipulation of their earnings in the issuing year. However, the Mahalanobis distance approach does not provide similar results.

[Insert Table 12 about here]

Table 13 reports the regression results of abnormal returns on discretionary accruals and control variables for Japanese issuers. The coefficient of discretionary accruals in year 0 on three-year abnormal returns is -0.3143, which is significant at the 10 percent level. The coefficient of discretionary accruals in year 0 on five-year abnormal returns is -0.5794, which is also significant at the 10 percent level. This result is similar to results from the Mahalanobis distance approach for selecting the control sample.

[Insert Table 13 about here]

Thus, the propensity score matching approach provides results consistent with the Mahalanobis distance approach for both the U.S. and the Japanese studies. This implies that the findings of the study are not sensitive to the matching method adopted for selecting the control sample.

CHAPTER 7 CONCLUSION

Private placements provide direct incentive to managers to manipulate earnings. In doing so, managers may portray a rosy picture of the firms' prospects to attract new investors and obtain more favorable terms for selling new shares. This study investigates whether U.S. private placement issuers manipulate their earnings around the time of issue, and the results indicate that U.S. managers tend to income increasingly manage their earnings around the private placement.

The study also examines the effect on stock performance of earnings management around the issue of private placements. Investors could be misled by the manipulated earnings and become over-optimistic about the issuers' future performances. When the income-increasing accruals reverse in subsequent periods, investors become disappointed and beat down the stock price to the firms' fundamental values. Thus, the study finds that post-issue stock underperformance is associated with earnings management prior to the private placement and that, the higher the level of earnings management before the issue of private placements, the poorer the post-issue stock performance will be.

The study further analyzes whether earnings manipulation around the time of private placements issuance and its impact on issuers' post-issue stock performance are demonstrated similar patterns in Japan. The results indicate that, like their U.S. counterparts, Japanese private placement issuers also manipulate their earnings around the time of issue and that the manipulated earnings predict the issuers' post-issue stock underperformance.

The study also investigates whether an alternative matching technique could have influence on the findings. A popular matching method in economics, propensity score matching, is used to replace the Mahalanobis distance approach and the results are similar, suggesting that the findings are not sensitive to alternative matching methods.

Testing earnings management using accrual models is a simultaneous test of earnings management and the validity of the accrual models (Kothari et al., 2005), so this study is limited by the accuracy of the accrual model that is adopted to capture the existence and level of earnings management. Although the study adopts the best performing accrual model, to the extent that the model could fail to correctly extract the discretionary portion from the total accruals, the results should be interpreted with caution.

This study is also limited by the effectiveness of the matching models in dealing with self-selection bias since issuing private placements could be an endogenous choice. To deal with the self-selection problem, this study conduct a sensitivity test using propensity score matching method. Issuing firms are matched with control firms by the similar probability to issue private placements. Although the consistent results using the propensity score matching method with the dimension by dimension matching using Mahalanobis distance are conforming, the robustness of this study is based on the assumption that unobserved private information should not explain outcome differentials between firms choosing to issue private placements and those choosing not to. A structural self-selection model could be the possible extension of the methodology in the future of this study.

The findings of this study document that on average firms issuing private placements have tendency to manipulate their earnings around the issuance. However, the magnitude of the manipulations is different across the issuing firms. It will be interesting to investigate what factors affect the firms' decision to manage earnings or the magnitude of the manipulations, whether these factors have similar impact on private placement issuers with other equity issuers, such as initial public offerings, seasoned public offerings, right offerings and convertible bond offerings, etc and whether these factors have similar impact across countries. These will be the extension of this study in the future.

APPENDIX A: NEW U.S. SEASONED SECURITY ISSUES OF CORPORATION BY TYPES OF OFFERINGS, 1996-2006

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Public offerings*	114.6	110.9	121.3	125.0	134.9	120.9	110.4	123.3	147.6	115.3	119.2
Private placements*	43.2	61.9	84.7	112.7	177.0	100.0	60.5	58.8	n.a.**	n.a.**	n.a.**
Total*	157.8	172.8	206.0	237.7	311.9	220.9	170.9	182.1			
% of Private placements	27.40%	35.80%	41.10%	47.40%	56.70%	45.30%	35.40%	32.30%			

Footnotes:

- a. Source: Board of Governors of the Federal Reserve System, Federal Reserve Bulletin.
- b. * Numbers are in billions of dollars.
- c. ** Not available. Federal Reserve Bulletin stops reporting private placement data after 2003.

APPENDIX B: TABLES

Table 1: Summary of U.S. private placements sample size and gross proceeds

Panel A: Sample size and gross proceeds by calendar year			
Year	Sample size	Percentage	Gross proceeds (million \$)
1989	17	4.89%	1,214.65
1990	13	3.74%	688.74
1991	14	4.02%	213.50
1992	25	7.18%	275.50
1993	25	7.18%	324.25
1994	19	5.46%	272.27
1995	16	4.60%	474.40
1996	15	4.31%	199.65
1997	16	4.60%	464.96
1998	7	2.01%	169.33
1999	18	5.17%	872.46
2000	40	11.49%	1,710.40
2001	123	35.34%	2,675.25
Total	348	100.00%	9,556.08

Panel B: Sample size and gross proceeds by industry classification			
Industry classification	Sample size	Percentage	Gross proceeds (million \$)
Mining	9	2.59%	221.76
Oil And Gas	6	1.72%	438.42
Food Products	6	1.72%	368.10
Chemical Products	94	27.01%	2,218.40
Computer Equipment	16	4.60%	431.52
Electronic Equipment	25	7.18%	299.00
Transportation	18	5.17%	470.88
Instruments And Related Product	38	10.92%	677.54
Communications	12	3.45%	294.48
Wholesale	6	1.72%	69.90
Retail	21	6.03%	893.97
Financial Services	12	3.45%	482.88
Services	67	19.25%	1,886.05
Others	18	5.17%	801.54
Total	348	100.00%	9,556.08

Footnote:

The SEC required U.S. public firms to provide a cash flow statement starting in 1987. Since the study needs to calculate discretionary accruals two years prior to the issuance of private placements, the sample of issuers starts from 1989. Since the study also needs to calculate post-issue stock performance up to five years, the sample ends in 2001.

Table 2: Summary of Japanese private placements sample size and gross proceeds

Panel A: Sample size and gross proceeds by calendar year

Year	Sample size	Percentage	Gross proceeds (billion yen)
1977	29	10.58%	16.82
1978	17	6.20%	27.03
1979	13	4.74%	36.14
1980	7	2.55%	51.94
1981	11	4.01%	26.18
1982	8	2.92%	14.24
1983	11	4.01%	38.50
1984	7	2.55%	13.51
1985	12	4.38%	23.52
1986	10	3.65%	21.70
1987	9	3.28%	68.67
1988	12	4.38%	41.64
1989	9	3.28%	49.41
1990	8	2.92%	149.60
1991	11	4.01%	68.75
1992	14	5.11%	88.76
1993	8	2.92%	32.24
1994	3	1.09%	11.73
1995	9	3.28%	42.48
1996	7	2.55%	107.38
1997	10	3.65%	68.80
1998	17	6.20%	187.17
1999	32	11.68%	1,095.04
Total	274	100.00%	2,150.90

Footnote:

Since the study needs to calculate post-issue stock performance up to five years and PACAP database currently only provides Japanese financial information and stock returns up to 2004, the sample of the issuing firms ends in 1999.

Table 2: (Continued) Summary of Japanese private placements sample size and gross proceeds

Panel B: Sample size and gross proceeds by industry classification

Industry classification	Sample size	Percentage	Gross proceeds (billion yen)
Mining	4	1.46%	10.04
Construction	22	8.03%	180.84
Foods	12	4.38%	55.32
Textiles	8	2.92%	46.40
Pulp And Paper	5	1.82%	27.40
Chemicals	23	8.39%	85.10
Rubber	4	1.46%	5.08
Iron And Steel	7	2.55%	16.31
Nonferrous Metals	13	4.74%	48.10
Metal Products	4	1.46%	1.08
Machinery	37	13.50%	115.81
Electric Machinery	38	13.87%	212.80
Transportation Equipment	14	5.11%	821.94
Precision Equipment	13	4.74%	26.26
Other Manufacturing	5	1.82%	10.25
Wholesale	13	4.74%	81.38
Retail	10	3.65%	84.50
Real Estate	4	1.46%	15.32
Shipping	12	4.38%	54.00
Services	17	6.20%	81.09
Others	9	3.28%	173.16
Total	274	100.00%	2,150.90

Table 3: Discretionary accruals for U.S. issuing firms versus control firms

Variable	Mean	Std. Dev.	Median	Min	Max
Year -2 (N=289)					
PP firms	-0.0021 (t=-0.10, pr=0.920)	0.3535	0.0104 (pr=0.281)	-1.7926	1.2482
Control firms	0.0044 (t=0.24, pr=0.811)	0.2920	0.0045 (pr=0.444)	-1.2817	1.6583
Test of difference	(t=-0.23, p=0.815)		(pr=0.672)		
Year -1 (N=348)					
PP firms	0.0327** (t=2.15, pr=0.032)	0.2816	0.0249*** (pr=0.001)	-1.4318	1.5114
Control firms	-0.0072 (t=-0.64, pr=0.521)	0.2125	0.0051 (pr=0.782)	-0.8906	0.8037
Test of difference	(t=2.11, pr=0.035)		(pr=0.059)		
Year 0 (N=321)					
PP firms	0.0054 (t=0.39, pr=0.694)	0.2466	0.0128 (pr=0.307)	-1.1477	1.5460
Control firms	-0.0018 (t=-0.16, pr=0.874)	0.1991	0.0055 (pr=0.281)	-1.4221	0.7863
Test of difference	(t=0.40, p=0.687)		(pr=0.865)		
Year +1 (N=291)					
PP firms	0.0127 (t=1.20, pr=0.231)	0.1805	0.0143* (pr=0.066)	-0.6056	0.8132
Control firms	-0.0020 (t=-0.14, pr=0.886)	0.2189	-0.0080 (pr=0.627)	-1.1885	1.5788
Test of difference	(t=0.83, p=0.405)		(pr=0.157)		
Year +2 (N=260)					
PP firms	0.0193 (t=1.58, pr=0.114)	0.1963	0.0068 (pr=0.108)	-1.2727	1.1556
Control firms	-0.0130 (t=-0.95, pr=0.343)	0.1855	0.0023 (pr=0.553)	-0.8277	0.8948
Test of difference	(t=1.76, p=0.079)		(pr=0.187)		

Footnotes:

- Paired-sample t-test is used to evaluate difference in means, and Wilcoxon rank-sum test is used to evaluate the difference in medians.
- ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, two-tailed test.

Table 4: Discretionary accruals for Japanese issuing firms versus control firms

Variable	Mean	Std. Dev.	Median	Min	Max
Year -2 (N=264)					
PP firms	-0.0062 (t=-1.03, pr=0.303)	0.0982	-0.0017 (pr=0.330)	-0.4080	0.6855
Control firms	-0.0097 (t=-1.56, pr=0.119)	0.0993	-0.0155*** (pr=0.001)	-0.4071	0.7157
Test of difference	(t=0.40, p=0.691)		(pr=0.101)		
Year -1 (N=274)					
PP firms	-0.0217*** (t=-3.17, pr=0.002)	0.1132	-0.0161*** (pr=0.000)	-0.4431	0.4389
Control firms	-0.0119** (t=-2.39, pr=0.018)	0.0823	-0.0113*** (pr=0.002)	-0.4003	0.4813
Test of difference	(t=-1.16, pr=0.247)		(pr=0.432)		
Year 0 (N=248)					
PP firms	0.0582*** (t=5.94, pr=0.000)	0.1544	0.0343*** (pr=0.000)	-0.5112	0.5863
Control firms	-0.0059 (t=-0.91, pr=0.366)	0.1024	-0.0044 (pr=0.087)	-0.4583	0.5016
Test of difference	(t=5.45, p=0.000)		(pr=0.000)		
Year +1 (N=229)					
PP firms	0.0070 (t=0.90, pr=0.367)	0.1169	0.0046 (pr=0.364)	-0.3805	0.8264
Control firms	0.0056 (t=0.08, pr=0.937)	0.1136	-0.0036 (pr=0.831)	-0.4408	0.5411
Test of difference	(t=0.52, p=0.597)		(pr=0.397)		
Year +2 (N=218)					
PP firms	0.0037 (t=0.45, pr=0.653)	0.1214	0.0015 (pr=0.341)	-0.5996	0.8516
Control firms	-0.0092 (t=-1.52, pr=0.130)	0.0874	-0.0037 (pr=0.231)	-0.4870	0.3497
Test of difference	(t=1.26, p=0.208)		(pr=0.122)		

Footnotes:

- Paired-sample t-test is used to evaluate difference in means, and Wilcoxon rank-sum test is used to evaluate the difference in medians.
- ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, two-tailed test.

**Table 5: Post-issue stock returns for extreme discretionary accruals quartiles:
U.S. issuers**

Years after issuance	Raw returns		Market excess returns		Abnormal returns	
	Conservative	Aggressive	Conservative	Aggressive	Conservative	Aggressive
1	-11.73	-6.72	-8.49	-3.78	-23.16	-27.67
2	19.25	-5.03	12.91	-13.08	-21.49	-41.66
3	18.22	16.78	3.54	-9.75	-15.98	-51.21
4	34.17	35.39	2.08	-9.25	-12.71	-46.38
5	60.08	66.95	3.81	5.08	-12.82	-40.82

Footnote:

The total sample is classified into four groups by the issuer's discretionary accruals in the year preceding the issuing year. The conservative group is the quartile group with the smallest discretionary accruals and the aggressive group is the one with the largest discretionary accruals.

Table 6: Regressions of post-issue stock performance on discretionary accruals in year -1 and control variables for U.S. issuers

		Raw returns		Market excess returns		Abnormal returns	
		Three-year returns	Five-year returns	Three-year returns	Five-year returns	Three-year returns	Five-year returns
Discretionary Accruals	Coef (t)	-0.2327 (-1.22)	0.3023 0.91	-0.3485** (-1.96)	0.0612 (0.23)	-0.4343** (-1.83)	-0.0858 (-0.21)
Market Value	(t)	(0.12)	(1.24)	(-0.06)	(0.36)	(0.48)	(0.19)
Book to Market	(t)	(1.98)	(1.63)	(1.76)	(0.93)	(1.25)	(1.11)
Industry dummies		Not reported		Not reported		Not reported	
Obs		293	161	293	161	293	161
R-square		3.31%	6.04%	3.81%	3.19%	4.17%	4.68%

Footnotes:

- ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, one-tailed test.
- The regression model is as following,

$$R_i = \beta_0 + \beta_1 (DA_i) + \beta_2 (Size_i) + \beta_3 (BtoM_i) + \sum \gamma (Industry_dummies_i) + \varepsilon_i$$

Where,

R_i = issuer's raw return, market excess return, or abnormal return

DA_i = issuer's discretionary accruals around issuance

$Size_i$ = issuer's market value of equity

$BtoM_i$ = book to market ratio

$Industry_dummies_i$ = industry dummy variables

**Table 7: Post-issue stock returns for extreme discretionary accruals quartiles:
Japanese issuers**

Years after issuance	Raw returns		Market excess returns		Abnormal returns	
	Conservative	Aggressive	Conservative	Aggressive	Conservative	Aggressive
1	18.16	8.81	-0.64	-1.71	3.31	-8.57
2	26.86	10.15	-6.91	-13.57	-13.58	-22.07
3	20.38	7.29	-7.66	-19.28	-20.33	-28.54
4	34.91	23.12	-12.92	-22.32	-21.45	-40.99
5	51.39	32.43	-13.14	-24.58	-17.12	-47.77

Footnote:

The total sample is classified into four groups by the issuer's discretionary accruals in the issuing year. The conservative group is the quartile group with smaller discretionary accruals and the aggressive group is the one with larger discretionary accruals.

Table 8: Regressions of post-issue stock performance on discretionary accruals in year 0 and control variables for Japanese issuers

		Raw returns		Market excess returns		Abnormal returns	
		Three-year returns	Five-year returns	Three-year returns	Five-year returns	Three-year returns	Five-year returns
Discretionary Accruals	Coef (t)	-0.8679** (-2.16)	-1.1033** (-1.89)	-0.4292** (-1.98)	-0.3199* (-1.30)	-0.4302* (-1.36)	-0.6425* (-1.58)
Market Value	(t)	(-5.15)	(-3.44)	(-2.50)	(-1.68)	(-0.60)	(-0.81)
Book to Market	(t)	(-0.55)	(-0.95)	(-0.68)	(+0.40)	(-1.40)	-0.26
Industry dummies		Not reported		Not reported		Not reported	
Obs		219	202	219	202	219	202
R-square		19.01%	11.13%	8.00%	4.63%	7.08%	5.28%

Footnotes:

- a. ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, one-tailed test.
- b. The regression model is as following,

$$R_i = \beta_0 + \beta_1 (DA_i) + \beta_2 (Size_i) + \beta_3 (BtoM_i) + \sum \gamma (Industry_dummies_i) + \varepsilon_i$$

Where,

R_i = issuer's raw return, market excess return, or abnormal return

DA_i = issuer's discretionary accruals around issuance

$Size_i$ = issuer's market value of equity

$BtoM_i$ = book to market ratio

$Industry_dummies_i$ = industry dummy variables

Table 9: Logistic analysis of private placement decision

Independent variables	Dependent Variables			
	US firms		Japanese firms	
	Coefficient	z-stat	Coefficient	z-stat
Return on Assets	-0.0906**	-2.10	-8.6509***	-5.60
Leverage	0.0694	0.50	4.7263***	9.29
Size	-0.0855***	-2.83	-0.6258***	-10.72
R & D/ Assets	0.4763**	2.54		
Book to Market	-0.1761***	-3.88	-0.6416***	-2.69
Sales/Assets	-0.5164***	-5.06	-0.2781**	-2.10
Traded on American Stock Exchange	0.3466	1.52		
Traded on NASDAQ	0.2589*	1.89		
Industry Dummies	3 are significant		2 are significant	
Year Dummies	5 are significant		4 are significant	
Intercept	-4.5894***	-10.82	-0.5517	-0.65
Number of Obs	36942		24531	
Pseudo R-square	11.59%		20.67%	

Footnotes:

- a. ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively.
- b. The dependent variable is 1 if a firm issues private placement in a certain year and 0 otherwise.

Table 10: Discretionary accruals for U.S. private placement firms versus control firms – propensity score matching

Variable	Mean	Std. Dev.	Median	Min	Max
Year -2 (N=289)					
PP firms	-0.0021 (t=-0.10, pr=0.920)	0.3535	0.0104 (pr=0.281)	-1.7926	1.2482
Control firms	0.0081 (t=0.52, pr=0.601)	0.2920	0.0102* (pr=0.059)	-1.7113	1.2321
Test of difference	(t=-0.39, p=0.694)		(pr=0.869)		
Year -1 (N=348)					
PP firms	0.0327** (t=2.15, pr=0.032)	0.2816	0.0249*** (pr=0.001)	-1.4318	1.5114
Control firms	-0.0100 (t=-0.56, pr=0.577)	0.2125	0.0062 (pr=0.957)	-1.7070	1.5687
Test of difference	(t=1.82, pr=0.069)		(pr=0.042)		
Year 0 (N=321)					
PP firms	0.0054 (t=0.39, pr=0.694)	0.2466	0.0128 (pr=0.307)	-1.1477	1.5460
Control firms	0.0050 (t=-0.39, pr=0.695)	0.1991	0.0060 (pr=0.420)	-1.4365	1.1002
Test of difference	(t=0.02, p=0.983)		(pr=0.662)		
Year +1 (N=291)					
PP firms	0.0127 (t=1.20, pr=0.231)	0.1805	0.0143* (pr=0.066)	-0.6056	0.8132
Control firms	-0.0102 (t=-0.78, pr=0.435)	0.2189	-0.0030 (pr=0.996)	-0.9299	1.1316
Test of difference	(t=1.36, p=0.173)		(pr=0.171)		
Year +2 (N=260)					
PP firms	0.0193 (t=1.58, pr=0.114)	0.1963	0.0068 (pr=0.108)	-1.2727	1.1556
Control firms	-0.0072 (t=-0.78, pr=0.434)	0.1855	-0.0032 (pr=0.970)	-0.6795	0.5421
Test of difference	(t=1.73, p=0.083)		(pr=0.526)		

Footnotes:

- Paired-sample t-test is used to evaluate difference in means, and Wilcoxon rank-sum test is used to evaluate the difference in medians.
- ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, two-tailed test.

Table 11: Regressions of post-issue stock performance on discretionary accruals in year -1 and control variables for U.S. issuers – propensity score matching

		Raw returns		Market excess returns		Abnormal returns	
		Three-year returns	Five-year returns	Three-year returns	Five-year returns	Three-year returns	Five-year returns
Discretionary Accruals	Coef (t)	-0.2327 (-1.22)	0.3023 (0.91)	-0.3485** (-1.96)	0.0612 (0.23)	-0.5082* (-1.43)	0.0776 (0.23)
Market Value	(t)	(0.12)	(1.24)	(-0.06)	(0.36)	(-0.05)	(0.41)
Book to Market	(t)	(1.98)	(1.63)	(1.76)	(0.93)	(0.04)	(0.80)
Industry dummies		Not reported		Not reported		Not reported	
Obs		293	161	293	161	293	161
R-square		3.31%	6.04%	3.81%	3.19%	4.48%	6.31%

Footnotes:

- ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, one-tailed test.
- The regression model is as following,

$$R_i = \beta_0 + \beta_1 (DA_i) + \beta_2 (Size_i) + \beta_3 (BtoM_i) + \sum \gamma (Industry_dummies_i) + \varepsilon_i$$

Where,

R_i = issuer's raw return, market excess return, or abnormal return

DA_i = issuer's discretionary accruals around issuance

$Size_i$ = issuer's market value of equity

$BtoM_i$ = book to market ratio

$Industry_dummies_i$ = industry dummy variables

Table 12: Discretionary accruals for Japanese private placement firms versus control firms – propensity score matching

Variable	Mean	Std. Dev.	Median	Min	Max
Year -2 (N=264)					
PP firms	-0.0062 (t=-1.03, pr=0.303)	0.0982	-0.0017 (pr=0.330)	-0.4080	0.6855
Control firms	-0.0024 (t=-0.51, pr=0.608)	0.0993	0.0000 (pr=0.605)	-0.3051	0.3200
Test of difference	(t=0.51, p=0.610)		(pr=0.262)		
Year -1 (N=274)					
PP firms	-0.0217*** (t=-3.17, pr=0.002)	0.1132	-0.0161*** (pr=0.000)	-0.4431	0.4389
Control firms	-0.0072* (t=-1.70, pr=0.090)	0.0823	-0.0032 (pr=0.160)	-0.3236	0.2113
Test of difference	(t=-1.80, pr=0.072)		(pr=0.061)		
Year 0 (N=248)					
PP firms	0.0582*** (t=5.94, pr=0.000)	0.1544	0.0343*** (pr=0.000)	-0.5112	0.5863
Control firms	-0.0023 (t=-0.54, pr=0.590)	0.1024	-0.0035 (pr=0.677)	-0.2863	0.2288
Test of difference	(t=5.65, p=0.000)		(pr=0.000)		
Year +1 (N=229)					
PP firms	0.0070 (t=0.90, pr=0.367)	0.1169	0.0046 (pr=0.364)	-0.3805	0.8264
Control firms	0.0078* (t=1.77, pr=0.079)	0.1136	0.0034 (pr=0.182)	-0.2547	0.2324
Test of difference	(t=-0.09, p=0.931)		(pr=0.866)		
Year +2 (N=218)					
PP firms	0.0037 (t=0.45, pr=0.653)	0.1214	0.0015 (pr=0.341)	-0.5996	0.8516
Control firms	0.0064 (t=1.31, pr=0.192)	0.0874	0.0040 (pr=0.375)	-0.2444	0.3200
Test of difference	(t=-0.29, p=0.775)		(pr=0.941)		

Footnotes:

- Paired-sample t-test is used to evaluate difference in means, and Wilcoxon rank-sum test is used to evaluate the difference in medians.
- ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, two-tailed test.

Table 13: The regressions of post-issue returns on discretionary accruals in year 0 and controls for Japanese issuers-propensity score matching

		Raw returns		Market excess returns		Abnormal returns	
		Three-year returns	Five-year returns	Three-year returns	Five-year returns	Three-year returns	Five-year returns
Discretionary Accruals	Coef (t)	-0.8679** (-2.16)	-1.1033** (-1.89)	-0.4292** (-1.98)	-0.3199* (-1.30)	-0.3143* (-1.34)	-0.5794* (-1.65)
Market Value	(t)	(-5.15)	(-3.44)	(-2.50)	(-1.68)	(-0.73)	(-0.08)
Book to Market	(t)	(-0.55)	(-0.95)	(-0.68)	(+0.40)	-0.01	(-0.44)
Industry dummies		Not reported		Not reported		Not reported	
Obs		219	202	219	202	219	202
R-square		19.01%	11.13%	8.00%	4.63%	7.54%	2.20%

Footnotes:

- ***, **, *: Significant different from zero at 0.01, 0.05, and 0.10, respectively, one-tailed test.
- The regression model is as following,

$$R_i = \beta_0 + \beta_1 (DA_i) + \beta_2 (Size_i) + \beta_3 (BtoM_i) + \sum \gamma (Industry_dummies_i) + \varepsilon_i$$

Where,

R_i = issuer's raw return, market excess return, or abnormal return

DA_i = issuer's discretionary accruals around issuance

$Size_i$ = issuer's market value of equity

$BtoM_i$ = book to market ratio

$Industry_dummies_i$ = industry dummy variables

APPENDIX C: FIGURES

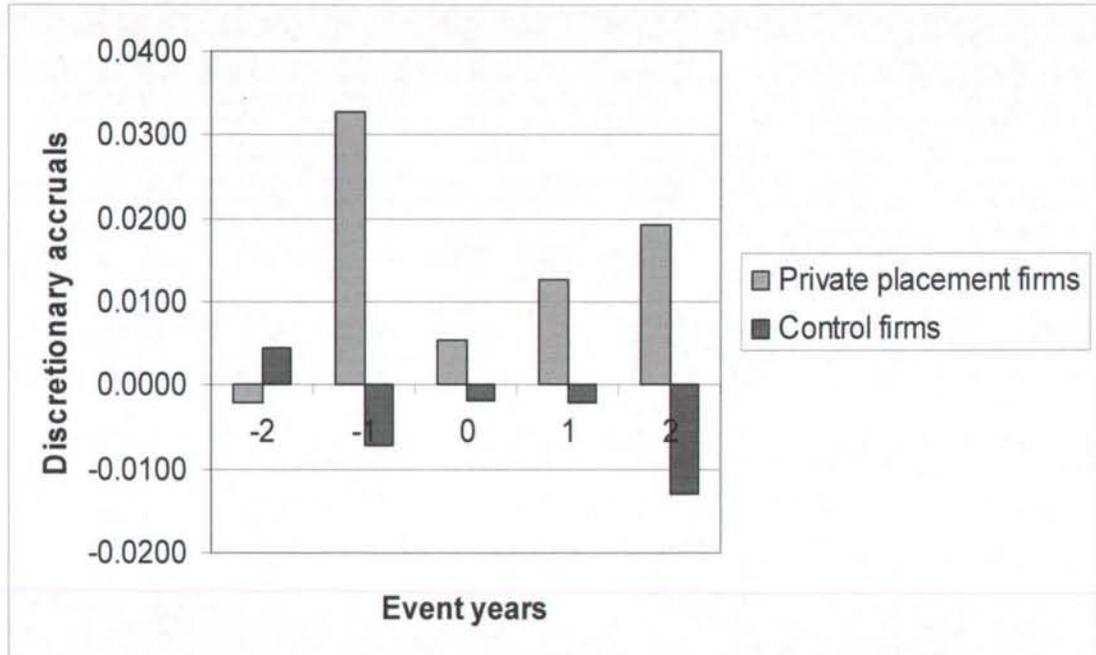


Figure 1: Discretionary accruals for U.S. issuing firms and control firms

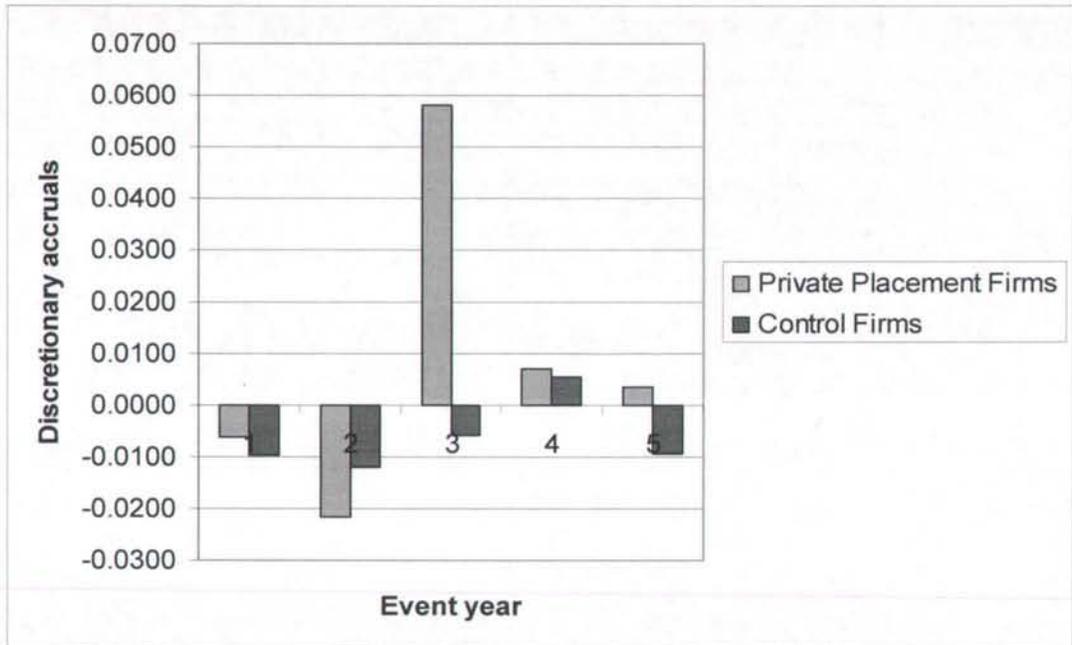


Figure 2: Discretionary accruals for Japanese issuing firms and control firms

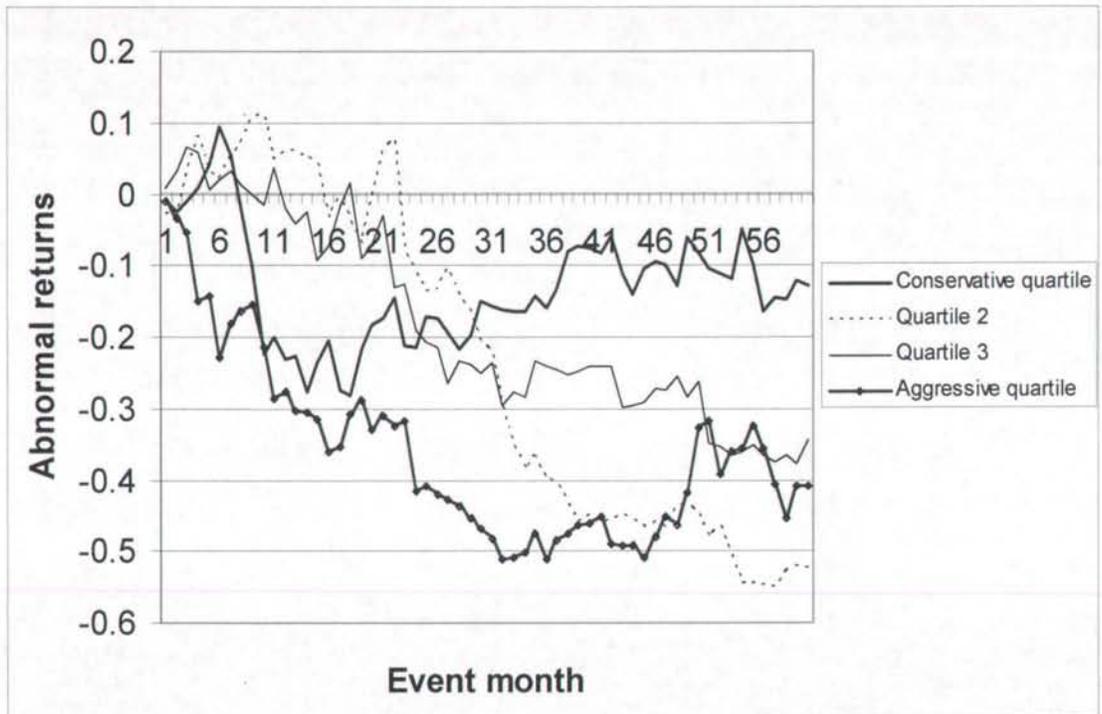


Figure 3: Abnormal returns classified by discretionary accruals around issue year quartiles for U.S. issuers

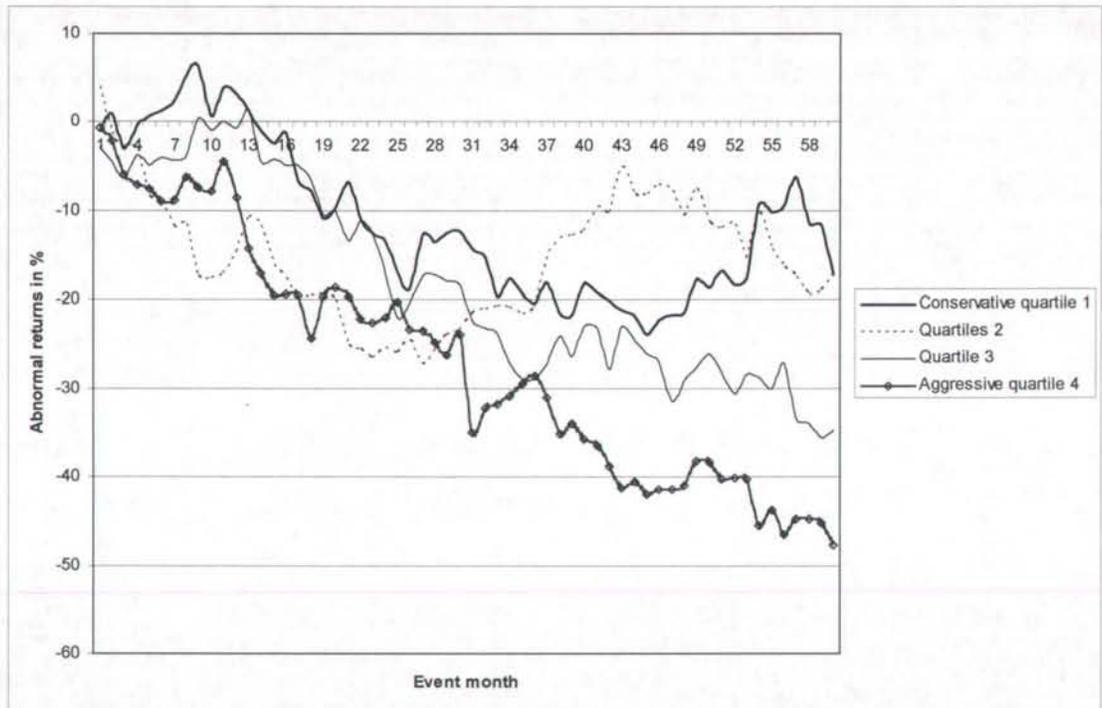


Figure 4: Abnormal returns classified by discretionary accruals around issue year quartiles for Japanese issuers

ENDNOTES

¹ It is arguable that discounts offered to the private placement investors may somewhat reflect the concern of private placement investors on reported earnings. However, offering discounts can help attract more institutional investors, increasing the pool from which managers can select based on their preference; offering discounts may also help issuing firms bring more capital quickly. In the meantime, there is a restricted time period for private placement investors to re-sell their securities - discounts may be used to compensate for this liquidity problem. Given the variety of roles of discounts, it is difficult to distinguish the level of reflection on the concern of earnings quality.

² The SEC required U.S. public firms to provide a cash flow statement starting in 1987. Since the study needs to calculate discretionary accruals two years prior to the issuance of private placements, the sample of issuers starts from 1989.

³ The Japanese accounting standard for cash flow statements was issued in 1998. Japanese listed companies start to submit their cash flow statements from the year 2000.

⁴ Firms issuing public offerings and private placements in year t are also excluded in the cross-sectional regression estimating the parameters of equation (3).

⁵ Paired-sample t-test is used to evaluate difference in means and Wilcoxon rank-sum test is used to evaluate the difference in medians.

⁶ Paired-sample t-test is used to evaluate difference in means and Wilcoxon rank-sum test is used to evaluate the difference in medians.

⁷ Frankel et al. (1995) find that US firms issuing more capital tend to issue more forecasting. Francis et al. (2005) using a sample of 672 observations from 34 countries outside of the United State, also document that firms in industries with great external financing needs have higher levels of voluntary disclosure.

⁸ Gramlich and Sorensen (2004) examine a sample of 58 Danish firms that issue voluntary earnings forecasts in connection with IPOs and find that managers of Danish firms exercise discretionary accruals to mitigate earnings forecast errors.

⁹ Paired-sample t-test is used to evaluate difference in means and Wilcoxon rank-sum test is used to evaluate the difference in medians.

¹⁰ The only difference between Table 11 and Table 6 is in the abnormal returns sections.

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