

Disclosure Costs and Earnings Management: Evidence from Stock-for-stock Acquisitions

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Abstract

This study examines whether costs associated with disclosing proprietary information explain differential levels of earnings inflation by acquirers before stock-for-stock acquisitions. I hypothesize that disclosure costs hinder acquirers' ability to signal the absence of earnings inflation to targets. This leads to a separating equilibrium whereby acquirers with high disclosure costs but not acquirers with low disclosure costs inflate earnings before stock-for-stock acquisitions. Using acquirers' market-to-book ratio and industry concentration as proxies for disclosure costs, I find that acquirers with high disclosure costs have greater pre-acquisition abnormal accruals than acquirers with low disclosure costs. However, target managers are not misled and respond to acquirers' earnings inflation by demanding a higher exchange value such that the final acquisition premium is not affected by acquirers' earnings inflation. Finally, upon acquisition announcements, the market discounts pre-acquisition abnormal accruals of acquirers with high disclosure costs but not acquirers with low disclosure costs. Overall, the results suggest that earnings inflation by stock-for-stock acquirers seems to be a rational response to targets' expectations when high disclosure costs prevent acquirers from credibly signaling the absence of earnings inflation.