THE EFFECTS OF EARNINGS MANAGEMENT ON ACQUIRING FIRM’S POST-ACQUISITION PERFORMANCE

(An Empirical Study in Indonesian Public Acquiring Firms from 2006-2017)

THESIS

Submitted as one of the requirements
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DECLARATION OF ORIGINALITY

By this, I, Adinda Djatmiko, declare that this thesis with the title of: **THE EFFECTS OF EARNINGS MANAGEMENT ON FIRM'S POST-ACQUISITION PERFORMANCE (An Empirical Study in Indonesian Public Acquiring Firms from 2006-2017)** is purely my own writing. I declare that this thesis does not contain any context that is written by another author either partial or as a whole which I took by plagiarizing or copying into a sentence or symbols that represents ideas, opinions, or thoughts from other authors that by then I state it as my own. There are no sentences either partial or as a whole that I copy, imitate or took from another author without stating the original author.

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MOTTO AND DEDICATION

"Glass half empty, glass half full. Either way you won't be going thirsty, count your blessings not your flaws"

(Lauren Aquilina)

"Don't expect things when you can't accept things "

This thesis is dedicated to my beloved:

Mother, Sri Lestari

Father, Eko Djatmiko

My Supervisor, Mr. Fuad

The rest of my family and friends

ABSTRACT

This study aims to examine the effects of earnings management conducted by public acquiring firms on subsequent post-acquisition performance. The earnings management are separated into Accrual Management, Sales manipulation, abnormal discretionary expenditures, and abnormal production cost.

The number of samples were determined using the purposive sampling method, which obtained a total of 259 samples, consitsted of 37 public companies that are engaging in an acquisition and completed said deals from 2009-2014. Panel Regression on Econometric Views 10th Edition was used to examine the data. Findings of this study show that managing earnings through accruals would affect the company's post-acquisition performance, overproduction seems to generate the same result. Meanwhile, manipulating sales and altering discretionary expenditures did not significantly affect company's post-acquisition performance.

Keywords: Acquisition, firm's performance, accrual management, and real earnings management.

ABSTRAK

Penelitian ini bertujuan untuk menguji pengaruh manajemen laba yang dilakukan oleh perusahaan pengakuisisi public terhadap kinerja perusahaan setelah akuisisi. Strategi manajemen laba pada penelitian ini terbagi atas manajemen laba akrual, manipulasi penjualan, perubahan pada biaya-biaya diskresioner, dan perubahan pada produksi.

Jumlah sampel ditentukan dengan menggunakan metode purposive sampling, diperoleh sebanyak 259 sampel yang terdiri atas 37 perusahaan publik yang menyelesaikan akuisisinya pada 2009-2014. Regresi panel pada Econometric Views 10th Edition digunakan untuk menguji hipotesis. Hasil penelitian ini menunjukkan bahwa strategi mengelola laba secara akrual memiliki dampak pada kinerja perusahaan setelah akuisisi, begitu pula efek yang ditimbulkan oleh produksi berlebih. Sedangkan, manipulasi penjualan dan perubahan biaya diskresioner tidak memiliki pengaruh yang signifikan terhadap kinerja perusahaan setelah akuisisi.

Kata kunci: Akuisisi, kinerja perusahaan, manajemen laba akrual, dan manajemen laba riil.

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The author realizes that this thesis is far from being perfect. Therefore, critics, suggestions, and feedbacks are much appreciated in order to improve the quality of this research. The author sincerely hopes that this thesis could provide the readers with some insights. The author sincerely thanked all parties for the help and support.

Semarang, April 15th 2019

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CHAPTER I

INTRODUCTION

1.1 Background Problem

A series of mergers and acquisitions has fluctuated over the past few years, -both Cash based acquisition and Stock based Acquisition, or even a combination of both- in frequency and in volume. Acquisition is also a common topic in Indonesia. In 2014, there are 108 acquisition deals being made in Indonesia out of the 30.266 deals all around the world in the same year with the value of 5 Billion US Dollars, in the year 2015, although much less than the preceding year, Indonesia has a total value of 1.4 Billion US Dollars of acquisitions, the amount increases in the following year at 5.5 Billion US Dollars and in 2017 increases even more at 6.1 Billion US Dollars.

There are a lot of motives behind the strategy to acquire a company and each company might have its own reason that cannot be generalized. Despite the varying motives, it is agreeable that everyone wants what's best for their company and Mergers and Acquisitions (M&A) is just one strategy amongst many others to benefit their own company. M&A is just another way to amplify firms' growth when firms favored inorganic growth over organic growth. However, acquisition is not without a risk. There are many risks that a company might encounter, moreover if their pre-acquisition assessment is flawed, then they are bound to face some failures, one being not able to reach the perceived synergies.

Ideally, M&A is supposed to improve a company's value, thus enabling the term value creation. However, M&As are characterized by high rates of failure according to Hubbard (2014). How does one mitigate this risk of failure? Up until now there isn’t any definitive answer as to why an acquisition failed, simply because many has reached the conclusion that problems surrounding mergers and acquisition require contingency approach, a study by Dragoni (2017) confirms this and states that every situation is different.

Overpayment and non-materialized perceived synergies are commonly found on M&A literatures, as the contributing factors on why said acquisition failed to meet its expectations. The acquisition premium itself arises from numerous causes such as managerial hubris, synergy evaluation, or even information asymmetry, according to a study conducted by Malhotra *et al.*, (2018).

Manipulating earnings is a common move that is anticipated not without scrutiny in important corporate events. Nonetheless, even under scrutinized observation, manipulation still exist in many forms. An infamous approach to manipulate earnings is to employ Earning Management, although we have to note that not every earnings management action automatically equates to illegal practice.

While the predicament is setting-specific, it is not a peculiar instance where target firms that are actively seeking a buyer are engaging in Earning Management Practices, what is rather unusual is that these firms are engaging in downward earnings management as opposed to upwards earnings management, seeing that it will be seen as a more attractive investment price-wise and another motive is that they will appear to be transparent of the possible problems preceding the event, although an effective due diligence assessment on the bidders' part could deter from expressing an interest for said target, as briefly stated in a study conducted by Anagnostopoulou and Tsekrekos (2014).

Acquiring firms have the same, -if not more- incentive to alter their reported earnings as the 'buyer' in the scenario. This research is done in order to study the effects of acquiring firms' decision to manage earnings on its subsequent firm performance.

Previous research studied the possibility of acquiring firms engaging in earnings management activities prior to important corporate events, specifically in the events of Mergers and Acquisitions. Erickson and Wang (1999) pointed out that in the merger settings, acquiring firms manage their earnings upwards in the quarters preceding the event in order to inflate their stock price. Consistent with the general concept, Ardekani (2012) indicated that share acquirer firms in particular, managed their earnings upward a year prior to the announcement date for the acquisition, an idea that is also shared by Botsari and Meeks (2007). Disproving prior findings, Pungaliya and Vijh (2009) argued that there is no evidence of EM practices by stock acquirers.

It is without a doubt that past scandals influenced the public scrutiny when it comes to assessing a firm's value. Stakeholders are more keen on their observation to avoid making grave mistakes in the form of investments. It is only logical that prior to making huge corporate decision, in this case M&A, managers and the top executives raise their suspicions and act accordingly, with skepticism.

Ideally, that is what is supposed to be happening, especially with many literatures and models developed to help practitioners to discover manipulation in earnings. Nonetheless, Shleifer *et al.*, (2003) stated that target firms' managers might still agree to seal the deal albeit knowing that the acquiring firm over-evaluated their value because they (target firm's manager) are promised certain incentives such as accelerated stock options and continuing their employment, another reason is when the target firm's managers have the incentive to cash out their firm through acquisition. Supporting the notion, overpayment can be seen as a strong incentive for opportunistic managers to exploit the mispricing, according to an article written by Gu and Lev (2011).

Several literatures in the past have been made regarding EM activities prior to important corporate events, mainly focused on the Accrual Management part of the Earnings Management practice and tend to not go into details with the Real Earnings Management activities. The writer thinks that it is important to understand the implication of employing Earnings Management practices –both accrual management (Hereafter, AM) and Real Earnings Management (Hereafter, REM)- on acquiring firms' behalf around the acquisition timeline. In her research, Gunny (2010) mentioned that REM might be more plausible compared to AM when certain conditions applied: The firm has limited flexibility in using accruals and AM is riskier under SEC scrutiny. In their study, Graham, Harvey and Rajgopal (2005) acknowledged that managers favored achieving EM through REM as opposed to AM, even when they have to sacrifice positive NPV project in order to gain short-term earnings benchmark. The plausible logic behind that is because after the scandal in the year of 2000, reformation of regulations has been made in order to constrain AM practices and AM is seen as a riskier move compared to its counterpart, REM.

The writer is interested in studying both means of EM practices –AM and REM- around the acquisition timeline and the outcome of such actions in terms of firm’s post-acquisition performance. While it is more common for the stock-based acquisitions to be directly influenced by said EM practice, cash-based acquisitions might also be affected by EM practices and the writer wishes to study the implication.

The following part will describe Indonesia’s current state in terms of acquisition. Dezan Shira and Associates released an article on ASEAN Briefing official website in 2016 stating that Indonesia is one of the three countries in ASEAN to be the core of M&A, retaining around one third of all value. This strong position of Indonesia represents a large regional interest in the process of M&A and intra-ASEAN expansion, which shows that Indonesian market is not to be overlooked. Hence why, the author suggests that going more in depth about possible problems surrounding acquisition in Indonesia is to be expected since it is and will continue to be a relevant case, at least in the near future.

Indonesian government enacted the Presidential Regulation No.44 of 2016 (Peraturan Presiden Nomor 44 Tahun 2016) which was released on May 18th 2016 and consists a set of new negative investment list that revoked the negative list in 2014. This was revised in order to increase Indonesia’s competitiveness regarding AEC and Foreign Direct Investments in Indonesia.

The amendments made in 2016's list consists of several sectors that previously have been closed but have been opened since then. Some of the changes including several sectors that have been completely removed from the 2014's negative list, which means those companies could legally run as fully owned (100%) foreign investment. According to Badan Koordinasi Penanaman Modal (BKPM), the Indonesian Negative Investment List is made to protect Indonesian economy and to provide more business opportunities to investors, although there are still some sectors that are entirely closed to investments (both domestic and foreign investment) such as national defence, health or environmental grounds, and activities related to the distribution of sea coral and marine salvage.

The rate of M&A in Indonesia fluctuates slightly -as briefly shown in the first paragraph- with that being said, not all M&A deals in Indonesia have disclosed the value of the M&A deal, in fact it is safe to assume that most firms keep this information as confidential and only publish the value of target firms without disclosing its premium. The latest most significant deal to be made for the last 5 years is the takeover of the global mining giant, PT. Newmont Nusa Tenggara by Medco Energi Internasional, with a deal worth of USD 2.6 Billion. While the mining industry holds the biggest value in terms of deal size in 2017, followed by infrastructure category, economist predicts that in the near future, technology sector will be an attractive market in terms of M&A deals, citing three main contributing factors : (1) the projection of internet and smartphone penetration by the year of 2020, (2) A population of around 270 million by the year 2020 with half of the population belongs to the middle affluent class, and (3) The existence of several regulatory government incentives. This phenomenon has already started, seeing that 32% of the M&A deals are coming from technology sector, with Go-Jek and the Chinese Tencent Holdings sealing the deal of USD 1.2 Billion. Indonesian acquisition trend is dominated by private companies, however with that being said, many public acquisitions are still being made up to this day.

In 2018, Indonesia ranked 73rd on the World Bank's Ease of Doing Business, while it is still 33 ranks short from becoming the top 40 as President Joko Widodo has set as his target, it is still an improvement since merely three year ago Indonesia ranked 114th place. Indonesia scored 67.96 out of a hundred in the report's aggregate measurement. This shows that Indonesia still has a market for investors to store their investments but even with that, many still hesitate do their business in Indonesia. In fact, in an interview back in 2017, OJK's chairman of the board of commissioners, Muliaman Hadad, said that Indonesia is still among the lower ranks in Corporate Governance in ASEAN. A study conducted by Chen, Elder and Hsieh (2007) implied that the lack of independencies of supervisors and directors are associated with upwards earnings management. Independence here being one of the key factors of Good Corporate Governance. Hence why it is really important to conduct a further study on acquisition cases and problems surrounding acquisitions in Indonesian setting.

In the context of acquisitions, we should not neglect the possibility of earnings management. Managers are responsible to report the result of firm's operational activity and its financial position to the owners and other stakeholders in the form of financial report. Managers would want to report successful outcomes to the owners and stakeholders, however with such heavy duties they put upon themselves, it is not a rarity for managers to manipulate their earnings in the financial statement to match the desired amount. Although not all alterations made are of malicious intentions to scam the stakeholders and some still disagree with the idea that earnings management is unjustifiable, some do support the idea that any action taken to mislead the users are still called earnings management and is still not permitted. Supporting previous statement, Indonesia's low rank for good corporate governance might indicate that several undesired actions are still taken by the managers to help them reflect a satisfactory outcome, M&A cases are no exception.

In Indonesia, there are several cases of Earnings Management happening here. For instance, when PT Agis was proven by the inspection done by Badan Pengawas Pasar Modal or BAPEPAM back in 2007 to have given false information regarding the earnings of the two companies they acquired, PT. Akira Indonesia and PT TT Indonesia. PT Agis stated that both subsidiary companies generated earnings of Rp. 800 billion while in fact with both companies combined, the earnings only reached Rp. 466,8 Billion. This sure will mislead the users in making decisions since investor really take earnings as a major consideration before deciding on an investment. So while we couldn't applaud PT. Agis for misstating information, it supports the idea that managers are trying to give information that will boost up the firm's value and management quality to the investors.

To sum it up, Indonesia's current predicament shows that acquisition is and will continue to be a relevant case in the near future, implied by the placement as one of the three ASEAN countries to be the core of Intra ASEAN expansion through M&A, although acquisition itself is characterized by a high rates of failure, which eventually leads firms' managers to use EM practice as a way to solve the possibility of failure. Earnings management practices are still common in Indonesia, illustrated in the prior paragraph. Supporting the notion, Indonesia still ranks low in World Bank's Ease of Doing Business and according to Muliaman Hadad, Indonesia is still among the lower ranks in Corporate Governance in ASEAN alone. All these reasons strengthen the need to study this topic even further.

The writer is interested in studying the consequences of Earning Management decisions undertaken by the acquiring firms in Indonesia since previous research mostly studied the effects in the United States settings. The writer wishes to get a better understanding on whether or not EM activities affect Indonesian acquiring firms' performance around the acquisition window in the same manner that it did in the developed countries, seeing that Indonesian market is still considered an emerging market by the MSCI Index (MSCI Inc., formerly known as Morgan Stanley Capital International). A noticeable acquisition trend in Indonesia is to acquire private companies than big ones and also to acquire small to medium sized companies, and while the magnitude and the deal size in Indonesian acquisition is not as big as developed countries, it is still important to comprehend the full effects of EM in M&A performance. This unique setting might reject previous findings or might strengthen them. As far as the writer's concern, no study has been taken regarding the consequences of EM on Indonesian firms' performance with an acquisition as a consideration.

1.2 Problem Formulation

A comprehensive view on the effects of Earnings management around the acquisition timeline is needed in order to construct a proper assessment that will help users on deciding further action by reflecting on current conditions. To better understand this matter, the research is based on mergers and acquisitions literature using scientific databases (Science Direct, Emerald Insight, SSRN, etc.).

This paper will be discussing the Earnings Management activities that were taken by acquiring firms around the acquisition and how said activity will influence the success of the acquisition, measured by the firm's post-acquisition performance. The writer separates the Earnings Management into two different categories in this case and is based on detailed literature:

1.2.1 Accrual Management and Acquisition

There are two different routes that can be conducted by firms that partake in Earnings Management. The first one that will be touched on this segment is called the Accrual Management and the second one, the Real Earnings Management or sometimes called Real Activities Management, will be on the next part. These differing options have their own distinctive characteristics. Accrual Management could be seen as attractive for various reasons, one being not as expensive as conducting Real Earnings Management where the firm has to sacrifice positive NPV, aside from that, engaging in REM is said to be less effortless. Although this strategy can only be applied when said accrual is available. Loutskina (2006) stated that firms that are engaging in M&A activities are more prone to overvalue themselves, -thus implying an EM practice- or more specifically, overvalued firms tend to excessively engage themselves into M&A and to prolong the overvaluation, they employed Accrual Management, which leads the writer into thinking that prior to an acquisition announcement, firms are engaging in Accrual Management and to prolong the effect, they continued employing the method even after the acquisition announcement. Previous research found that 100% stock acquiring firms are more likely to engage in Accrual management (Louis, 2015). It makes sense since these acquiring firms are exchanging through stock for stock method and they have more incentive to increase the price of their stock before an acquisition was announced. For cash acquiring firms, there is no extensive research on its relation to Accrual Management practice since cash acquiring firms do not engage in stock exchange, however this does not mean that cash acquiring firms can't employ earnings management practices. The justification of this behavior is that managers might have the incentive to report a 'desirable' report in which the earnings reached the target or exceeded the target even just one cent. The implication of this peculiar demeanor is that the shareholders might see this achievement as beneficial and therefore applauding the managers for their accomplishment, leading them to believe that the managers are doing a great job and might eventually approve their managers' proposal of doing an acquisition, whether the true nature of the acquisition itself is benevolent or malevolent. In a sense, if managers are deemed to be doing an outstanding job, it is not impossible that the shareholders would let the managers do as they please, thinking that what they're proposing is of good intentions. What we are going to be seeing is whether or not this management of company's accruals benefit the company in the long run, or will it decrease the future performance of said company when acquisition is in the picture. Hence why the question arises:

"Does accrual management affect the performance of a company when said company is engaging in an acquisition?"

1.2.2 Real Earnings Management and Acquisition

Admittedly, engaging in Real Earnings Management is more time consuming and pricier than its counterpart, accrual management. Nonetheless it is still very important to study the real earnings management. Accrual management and Real Earnings Management are believed to have a substitutive power, referring to a study by Alphonse and Zhang (2016), hence why although the former is more popular in scholar articles, the latter should not be neglected. It is important to study whether or not real earnings management practice affects acquiring firm's post-acquisition performance. While it is believed to be a time-consuming and pricier method, the REM might be favored over the AM method. This is because the REM method is said to be more complicated to detect, since they actually alter their company's operational activities. That explains why AM is more prone to be under public scrutiny compared to its counterpart, however it doesn’t mean that we should exclude REM from the research, in fact it provides us with more incentive to study the latter in a much more in depth manner. According to a study by Roychowdhury (2006), we could determine whether or not a company engages in earnings management through real earnings management using three proxies, each proxy will be explained in a detailed manner in the next segment, but the general questions are separated into:

“Does sales manipulation affect the performance of a company when said company is engaging in an acquisition?”

“Does altering discretionary expenditure affect the performance of a company when said company is engaging in an acquisition?”

“Does altering the production cost affect the performance of a company when said company is engaging in an acquisition?”

1.3 Research Objectives and Purposes

The purpose of this study is to gain a better understanding on the effects of both EM decisions employed by acquiring firms. The purpose of the study is described based on the formulation of the problem. The purpose of this research are:

1. To analyze the effect of accrual management undertaken by acquiring firms to said firm’s post-acquisition performance.
2. To analyze the effect of sales manipulation undertaken by acquiring firms to said firm’s post-acquisition performance.

3. To analyze the effect of discretionary expenditures alteration undertaken by acquiring firms to said firm's post-acquisition performance.
4. To analyze the effect of production cost alteration undertaken by acquiring firms to said firm's post-acquisition performance.

This study has several uses. This research can be utilized by the academicians and practitioners as well. For the practitioners, the results of this study is expected to become one of the accounting literature that can complement the existing literature on the practice of acquisitions, especially in the companies in Indonesia and hopefully to enable the readers on some insights regarding the practices of earnings management done from the acquiring firm's perspective and its effects on their company's performance.

For the writers themselves, this research is expected to increase the knowledge and understanding on the effects of different Earnings Management that were taken by acquiring firms to the success of an acquisition, measured by its performance.

For subsequent researchers, this research is expected to develop the next researchers' knowledge, focusing on acquisition practices, particularly in companies in Indonesia. This research can also be the main reference for other researchers to conduct further research.

1.4 Writing Systematics

Research writing is divided into 5 chapters:

CHAPTER I : INTRODUCTION

This chapter contains the introduction which is the basis of the study.

Introduction consists of background problems, problem formulation, research objectives, research purposes and systematics of writing. This introduction helps to understand the research in general.

CHAPTER II : LITERATURE REVIEW

This chapter contains a review of the research library. The library review consists of theoretical basis, previous research, the framework of thinking and the hypothesis. The library review helps to understand the basics of research.

CHAPTER III : RESEARCH METHODS

This chapter contains research methods. The research method consists of explanation of research variables, population and sample, type and source of data, and method analysis and hypothesis testing. The research method covers all aspects about the details of the data and how to analyze it.

CHAPTER IV : RESULT AND ANALYSIS

This chapter contains the description of the object of research, data analysis, and interpretation of results. Description of the object of research explaining the sample research and the process of determining the sample of the study population. The data analysis contains an explanation of the results of the analysis. Interpretation of the results contain further explanation of whether the results support or reject the hypothesis that has been formulated.

CHAPTER V : CONCLUSION

This chapter contains conclusions, research limitations as well as research suggestions. This conclusion is a brief presentation of what is obtained from the discussion. Limitations of the study describe the weaknesses and flaws found after analysis and interpretation of results. Suggestions contain future policy implications and research suggestions.