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Earnings management by friendly takeover targets

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Abstract

Purpose – Accounting research has emphasized target and bidder managers' incentives to manipulate earnings during corporate control contests. However, prior studies examining earnings management by takeover targets have obtained mixed results. Moreover, the existing evidence is mainly based on US data and hostile mergers and acquisitions (M&A) transactions. The purpose of this study is to examine earnings management by friendly takeover targets in the year preceding the deal announcement in Switzerland.

Design/methodology/approach – The paper examines earnings management practices of a sample of 50 Swiss firms that were targets of a friendly takeover proposition during the period 1990-2002. Discretionary accruals are used as a measure of earnings management. It uses a matching approach and a cross-sectional regression analysis to test the hypothesis of earnings management by takeover targets.

Research limitations/implications – The paper expands and provides further international insights to the existing literature through the investigation of earnings management by takeover targets managers in a European setting and in a friendly corporate control environment.

Originality/value – These empirical findings document the existence of a significant downward earnings management during the year preceding the transaction. These results suggest that earnings management incentives may differ between negotiated friendly and hostile disciplinary transactions.

Keywords Earnings, Accounting policy, Acquistions and mergers, Switzerland

Paper type Research paper

1. Introduction

This paper tests the hypothesis of earnings management by takeover targets in Switzerland during the year preceding the initiation of the transaction. Prior research (De Angelo, 1986; Easterwood, 1998; Erickson and Wang, 1999; North and O'Connel, 2002) suggests that managers of hostile takeover targets may have incentives to increase reported earnings either to convince shareholders to reject the offer since they are performing efficiently or to enhance the exchange ratio and raise the transaction price. However, the results of the few studies testing earnings management during M&A transactions are mixed. Easterwood (1998), North and O'Connel (2002) and Guan *et al.* (2004) provide evidence of earnings management by target firms while Erickson and Wang (1999) did not find any evidence of such practice. Moreover, the existing evidence is mainly based on US data and hostile mergers and acquisitions (M&A) transactions. We expand and provide further international insights to the existing

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literature through the investigation of earnings management by takeover targets managers in a European setting and in a friendly corporate control environment. To the best of our knowledge, this paper is one of the first studies to investigate earnings management by firms subject to takeovers in a European country.

Switzerland offers an interesting setting in which to test the hypothesis of earnings management by targets of a takeover attempt. The Swiss setting has specific characteristics such as an accounting regulation which prescribes few and rather flexible guidelines (Cormier *et al.*, 2000) leaving managers a great discretion in terms of accounting policy choice, and a concentrated and relatively illiquid stock market which differs from "stockholders oriented" countries (Missonier-Piera, 2004). This paper increases our understanding of managers accounting choices in such a "stakeholder's regime".

To date, few researchers have focused on the determinants guiding Swiss firms with regard to voluntary disclosure of financial information (Raffournier, 1995), the determinants of voluntary recourse to the international accounting standards (IAS/IFRS) (Dumontier and Raffournier, 1998), the contractual and value relevance of earnings (Cormier *et al.*, 2000) and the economic determinants underlying the accounting method strategies used by Swiss listed companies (Missonier-Piera, 2004). Our paper examines earnings management motivations in a specific context, namely firms subject to a takeover attempt, and thus contributes to this literature related to accounting choices made by Swiss firms.

We examine a sample of 50 Swiss firms that have been subject to a takeover between 1990 and 2002. We use discretionary accruals as a measure of earnings management. The existence of significant discretionary accruals in the year immediately preceding the initiation of the transaction would be consistent with the hypothesis that takeover targets' managers in Switzerland engage in an opportunistic earnings management. Contrary to US studies evidence, mainly based on hostile acquisitions, we find that friendly takeover targets managers engage in downward earnings management during the year preceding the initiation of the deal. These results suggest that managers' incentive to manage earnings may differ between disciplinary hostile transactions and friendly negotiated deals.

The remainder of the paper is organized as follows. Section 2 presents the specific features of the Swiss accounting and institutional environment. Section 3 summarizes the prior literature dealing with the earnings management in corporate control contests. In the fourth section, the research design is presented, i.e. the characteristics of the sample and the dependant variables. The empirical results are discussed in the fifth section and are followed by a conclusion in the last section.

2. Accounting in Switzerland

Like France and Germany, Switzerland has a civil code. The accounting choice of Swiss corporations must comply with the legal regulations of the Code of Obligations[1] (CO – Code Fédéral des Obligations). However, the CO contains only a minimum set of rules applicable to the disclosure of financial information and stipulates very few accounting principles. In theory, this absence of legal constraints allows firms to choose from a wide array of accounting procedures, with potentially strong impacts on their accounting policies. For example, corporations are legally free to use latent reserves to "smooth out" accounting results: "Supplementary latent reserves are admissible to the extent that they are justified to sustain the prosperity of the corporation or the distribution of a dividend stable enough to satisfy the interests of shareholders" (CO, Art. 669, para. 3, free translation from French). In practice, many Swiss firms seem to take into account the pressure of international markets. They try to present financial statements that apply established standards or comply with generally accepted practices. In Switzerland, as long as companies comply with the country's rather lax national regulations, they are free to use a number of accounting standards, including the International Financial Reporting Standards (IFRS), the Swiss GAAP RPC[2] and the European Directives[3]. However, the IFRS, the Swiss GAAP RPC and the European Directives allow a certain number of discretionary choices in the accounting methods used by corporations. Consequently, the Swiss system's lack of any real constraint over the choice of accounting and reporting standards, and the extent of the choice left open by international standards, combine to create an economic and institutional environment which offers a unique opportunity to examine the rationale underlying corporate accounting policy choices.

3. Related literature

Prior accounting research (De Angelo, 1986; Erickson and Wang, 1999) has discussed the theoretical motivations for earnings management during corporate control contests. Given the significance of reported earnings in the valuation of the target's shares (De Angelo, 1986), hostile takeover target managers may have incentives to raise accounting numbers prior to the takeover offer so as to increase the stock price and the deal value (Guan *et al.*, 2004). However, as suggested by Erickson and Wang (1999), target managers may choose not to manipulate reported earnings because the cost of earnings management detection is high in takeover situations. Both bidder's and target's managers have a fiduciary duty to ensure that reported earnings are free of significant accounting manipulation (Erickson and Wang, 1999). In such a context, Erickson and Wang (1999) argue that the detection of any earnings management may affect the price offered by the bidder and may ultimately threatens the completion of the transaction at the expense of shareholders.

While earnings management has been studied in a variety of contexts including compensation contracts, debt covenants, seasoned equity and initial public offerings (see Fields *et al.* (2001) for a review of this literature), there have been few studies related to corporate control contests.

Groff and Wright (1989) and Christie and Zimmerman (1994) test the hypothesis that managers of firms that are subject to takeover attempts are more likely to select income increasing accounting methods, during the years preceding the announcement of the takeover attempt, than the non-takeover targets firms in the same industry. These two studies consider that the mechanisms designed to align shareholders' and managers' incentives have failed in takeover targets firms and their managers may use income increasing accounting methods to mask their non-value-maximizing behavior. The empirical findings of both studies show that takeover targets make more income increasing accounting choices than non-takeover targets during the years preceding the initiation of the takeover attempt[4].

Easterwood (1998) examine whether managers of takeover targets manage earnings upward in the quarters preceding and following the initiation of the takeover offer. She reports significant earnings management during the quarter immediately preceding the takeover particularly for hostile transactions. Using a sample of 321 firms acquired over the 1990-1997 period and a modified version of the Jones (1991) model, North and O'Connel (2002) document that managers of target firms increase reported earnings in the quarters immediately preceding and following the initiation of the takeover attempt when the payment involves stock rather than cash consideration. More recently, Guan *et al.* (2004) provide evidence that hostile takeover targets managers engage in an upward earnings management during the year prior to the transaction.

In contrast, Erickson and Wang (1999) did not find any evidence of earnings management by target managers in a sample of 55 mergers and acquisitions completed in the United States between 1985 and 1999. Eddey and Taylor (1999) examined the association between directors' recommendations and abnormal accruals of a sample 43 takeover targets in Australia. According to the earnings management hypothesis, target directors who oppose the bid would manage earnings upward to convince shareholders to reject the bid due to the inadequate price offered. However, and contrary to their expectation, Eddey and Taylor (1999) found that takeover targets opposed to the bid engage in a significant downward earnings management.

The earnings management issue has also been investigated in the context of management buyouts (De Angelo, 1986; Perry and Williams, 1994; Wu, 1997; Begley *et al.*, 2003; Wright and Guan, 2004). Since managers have better information about the value of the firm than outside shareholders, they have incentives to manage downwards earnings in the periods preceding the MBO in the purpose to portray a less favorable picture of the firm and therefore to reduce the acquisition price (Perry and Williams, 1994). De Angelo (1986) examined this earnings management hypothesis prior to an MBO. She did not find any evidence supporting downward earnings manipulation during the periods preceding the MBO. In contrast, using the Jones (1991) model on a sample of 175 MBO between 1981 and 1988, Perry and Williams (1994) provide evidence of earnings management in the predicted direction in the year preceding the MBO. Wu (1997) also, using an industry-adjusted change in earnings as a measure of earnings management, found evidence that managers manipulate earnings downwards prior to making an offer to buy the firm. Recently, Begley *et al.* (2003) report evidence consistent with downward earnings management by managers of firms involved in MBO. They also show that good governance mechanisms (independent directors and incentive based compensation for the CEO) mitigate this opportunistic behavior.

The literature on earnings management during corporate control contests has so far obtained mixed evidence. Further, the existing evidence is mainly based on US data and little is known about earnings management by non-US takeover targets. Our study aims at contributing to the understanding of accounting choice in a more "stakeholder" oriented regime. Moreover, whereas prior research has mainly focused on earnings management during hostile takeovers in the US, this study examines managers' motivation to manipulate earnings in a friendly corporate control environment. Switzerland offers an interesting setting in which to examine earnings management by targets managers in friendly negotiated deals. Corporate ownership and control in Switzerland is highly concentrated as many European countries (Faccio and Lang, 2002) and hostile takeovers are not often.

Managers of hostile and friendly takeover targets may have different incentives to manipulate earnings. Hostile transactions are generally "disciplinary" where target managers are replaced by a new management team to implement different strategies and correct prior management inefficiencies (Morck *et al.*, 1988; Healy *et al.*, 1997; Powell, 1997). Thus, managers of hostile takeover targets may have incentives to manage earnings upward in the period prior and following the transaction to convince target shareholders to reject the offer, keep their positions within the firms and maintain all the private benefits associated with it.

On the other hand, friendly transactions involve long negotiations with the management team of the target and are not necessarily associated with a significant strategic change (Morck *et al.*, 1988; Healy *et al.*, 1997). Moreover, control premiums paid to targets shareholders are lower in friendly transactions than in hostile bids (Healy *et al.*, 1997). Finally, managers of friendly takeover targets generally retain their job after the transaction (Morck *et al.*, 1988; Dahya and Powell, 1998[5]) and continue to pursue the same strategic objectives during the post-merger period. Therefore, they may have incentives to reduce earnings in the periods preceding the transaction to facilitate the conclusion of the transaction, keep their managing positions and to report better results in the post-merger period.

4. Research design

Sample selection

The initial sample of target firms is composed of all industrial and commercial companies that were target of tender offers between 1990 and 2002, and listed on the Swiss Exchange (SWX). Our initial sample – obtained from SDC Thomson Financials database – consists of 138 tender offers representing 96 firms. One specific feature of this sub-sample is that all tender offers were friendly according to the SDC definition of hostility[6]. The elimination of firms without sufficient accounting information for the empirical analysis results in a final sample of 50 companies (Table I). A control sample is used to provide information on how comparable non-target firms differ from the test sample. The firms of the control group, also listed on the SWX, were matched individually to target firms on the basis of industry (two-digit SIC codes) and their size (i.e. the target firm's total sales), for the year prior to the tender offer. The data set was collected from annual reports of industrial and commercial listed companies available at the libraries of the universities of Geneva and Lausanne in Switzerland.

Descriptive statistics of target and control firms group for the year prior to the tender offer attempt are reported in Table II. Takeover target firms exhibit slightly higher assets and sales values than the control sample. On the other hand, they are associated with lower profitability (net income) and cash flows from operations than the control sample firms. Furthermore, takeovers target firms use more frequently

				Quartiles	
	Mean	Std. dev.	1st	2nd	3rd
Acquired shares (%)	65.29	32.55	34	67	100
Size of transactions (millions of Euros)	471.34	917.36	36.58	160.60	473.01
Tender offers > 20% of voting rights	138 (representing 96 firms)				
Firms with all data available	50				

Source: SDC Thomson Financials

Table I.
Descriptive statistics of the tender offers

	Mean	Std. dev.	Quartiles 1st	2nd	3rd
Panel A: target firms					
Sales	2,422.4	5,272.3	293.0	685.7	1,946.0
Assets	3,664.9	11,538.6	280.4	700.2	2,288.0
Net Income	157.5	638.7	4.6	28.5	83.0
CFO *	261.4	834.1	10.3	40.7	148.3
IAS/IFRS	0.50	0.50	0.00	0.00	1.00
Panel B: control firms					
Sales	1,937.2	4,683.4	269.7	582.9	1,500.7
Assets	2,614.7	8,588.8	231.1	629.5	1,532.8
Net income	207.3	937.9	3.5	18.8	66.2
CFO[a]	266.4	1,007.8	21.7	47.8	131.5
IAS/IFRS	0.44	0.50	0.00	0.00	1.00

Note: [a] Cash flow from operating activities

Table II. Descriptive statistics of the sample (in million CHF)

IAS/IFRS to present their financial statements than the control sample firms (50 percent compared to 43 percent). However, as shown in Table III, the difference between the two groups is not statistically significant at conventional levels.

Data definitions and models

This study focuses on earnings for the fiscal year ended immediately prior to the initiation of the tender offer attempt, as it is the most likely period to capture earnings management (Perry and Williams, 1994), although earnings management may have occurred several years prior to the offer. Similar to prior earnings management studies (Jones, 1991; Perry and Williams, 1994; Guan *et al.*, 2004), we assume that there is a systematic pattern of earnings management prior to friendly tender offers, which occurs through the manipulation of discretionary accruals. Similar to Dechow *et al.*

	Mean	Rank	Tests
Sales	$\mu_0 = 1{,}937.2$	$R_0 = 52.38$	$t = 0.503$
	$\mu_1 = 2{,}422.4$	$R_1 = 56.06$	$Z = -0.609$
Assets	$\mu_0 = 2{,}614.7$	$R_0 = 52.82$	$t = 0.540$
	$\mu_1 = 3{,}664.9$	$R_1 = 55.51$	$Z = -0.446$
Net income	$\mu_0 = 207.3$	$R_0 = 55.77$	$t = -0.312$
	$\mu_1 = 157.5$	$R_1 = 52.57$	$Z = -0.465$
CFO	$\mu_0 = 266.4$	$R_0 = 56.01$	$t = -0.027$
	$\mu_1 = 261.4$	$R_1 = 51.44$	$Z = -0.756$
IAS/IFRS	$\mu_0 = 0.43$	$R_0 = 49.86$	$t = -0.715$
	$\mu_1 = 0.50$	$R_1 = 53.50$	$Z = -0.717$

Notes: Subscript 0 corresponds to control firms, and subscript 1 to target firms. The t values and Z values are those resulting from the test (i.e. respectively the Student t test and Mann-Whitney U test) of the hypothesis that there is no difference between target and control firms. and R denote respectively the mean and the rank of each sub-sample

Table III. Comparison of means for descriptive statistics

(1995), we compute total accruals (TA) as the change in non-cash working capital less total depreciation expense:

$$
\begin{aligned}
TA = {} & [\Delta \text{Current Assets} - \Delta \text{Cash}] \\
& - [\Delta \text{Current Liabilities} - \Delta \text{Current portion of Long term Debt}] \\
& - \text{Depreciation and amortization exp ense}
\end{aligned}
$$

As discussed in prior accounting research (Dechow *et al.*, 1995), it is difficult to choose a relevant benchmark for what total accruals would have been without managers' discretionary accounting choice. As total accruals are composed of both discretionary and non-discretionary accruals, it is necessary to focus and isolate the discretionary component. We use the Jones (1991) model to distinguish between the discretionary and the non discretionary components[7]. This model includes two explanatory variables – revenues and gross property, plant and equipment (PPE) – that capture the changes in nondiscretionary accruals due to the level of economic activities for period into consideration (Jones, 1991). Revenue change takes into account the nondiscretionary changes in working capital accounts whilst gross PPE adjusts for the nondiscretionary depreciation expense (Jones, 1991; Perry and Williams, 1994). The regression-based expectations model is as follows:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha_i \left[\frac{1}{A_{i,t-1}}\right] + \beta_{1,i}\left[\frac{\Delta REV_{i,t}}{A_{i,t-1}}\right] + \beta_{2,1}\left[\frac{PPE_{i,t}}{A_{i,t-1}}\right] + \varepsilon_{i,t} \tag{1}$$

where:

$TA_{i,t}$	= total accruals in year t for firm i
$Ai,_{t-1}$	= total assets at year end $t-1$ for firm i
$\Delta REV_{it,-1}$	= $revenue_t$ minus $revenue_{t-1}$ for firm i
$PPE_{i,t}$	= gross property, plant and equipment at year end t for firm i
$\varepsilon i,t$	= error term in year t for firm i
i	= 1, ..., N firms
t	= 1, ..., T years (the estimation period ranges from 3 to 8 years).

The coefficients are estimated by ordinary least squares regression analysis. As with prior research (Perry and Williams, 1994), all variables in the regression are scaled by $A_{i,t-1}$ (i.e. total assets at year end $t-1$) to reduce heteroskedasticity problems in the data. Because time-series data necessary to estimate an individual firm model were not sufficient, the models are estimated on pooled data by industry (one-digit SIC code) where we use as many years as available prior to the hypothesized manipulation periods. This procedure provides coefficient estimates for each industry of the firm sample. Discretionary accruals (DA) or "abnormal accruals" are computed as follows, using the expected accruals obtained from model (1):

$$DA_{i,p} = \frac{TA_{i,p}}{A_{i,p-1}} - \left(a_i \left[\frac{1}{A_{i,p-1}} \right] + b_{1,i} \left[\frac{\Delta REV_{i,p}}{A_{i,p-1}} \right] + b_{2,i} \left[\frac{PPE_{i,p}}{A_{i,p-1}} \right] \right) \tag{2}$$

where:

$DA_{i,p}$ = discretionary accruals form firm i in hypothesized manipulation year p

a_i, $b_{j,i}$ = estimated coefficients ($j = 1, 2$) for expected accruals for firm i

p = predicted manipulations years

We use two methods to test for differences in earnings management practices between takeover targets and non-takeover control sample firms. First, we test for differences in discretionary accruals means in the year prior to the transaction between the takeover targets and control sample firms. Second, we use a regression analysis to regress accruals on selected explanatory variables with a dummy variable to capture differences in earnings management practices between the two groups of firms (firm type). Similar to Guan *et al.* (2004), control variables include cash flow from operations and return on equity (for firms' performance), Log of total assets (for political costs), leverage ratio (for debt covenant constraints). Two additional control variables are included in the model: a dummy variable (IAS) that takes the value 1 if the company report financial statements using IAS/IFRS (and 0 otherwise); and a dummy variable "Post 2000" that takes into account the market conditions that may have changed over the long period of investigation of the current study (1 if the takeover is after 2000 and otherwise).

$$\begin{aligned} DA_i = {} & a_1 + a_2 \log \begin{pmatrix} \text{Total} \\ \text{assets} \end{pmatrix}_i + \alpha_3 \begin{pmatrix} \text{Debt to} \\ \text{equity} \end{pmatrix}_i + \alpha_4 \begin{pmatrix} \text{Return} \\ \text{on equity} \end{pmatrix}_i \\ & + \alpha_5 \begin{pmatrix} \text{Operating} \\ \text{cash-flows} \end{pmatrix} + \alpha_6 \begin{pmatrix} \text{Firm} \\ \text{type} \end{pmatrix}_i \\ & + \alpha_7 (IAS)_i + \alpha_8 (\text{Post 2000})_i + \varepsilon_{i,j} \end{aligned}$$

5. Results

This paper predicts that friendly takeover targets managers may engage in a downward earnings management during the year prior to the tender offer. So, we expect that target firms would exhibit significant negative discretionary accruals during the year prior to the takeover. The results reported in Table IV provide support for the earnings management hypothesis. The mean abnormal accruals of the takeover target firms is negative and statistically significant (mean $= -0.038$; median $= -0.026$). The abnormal accruals of the control firms is slightly negative but not significantly different from zero (mean $= -0.008$; median $= 0.009$). These results suggest that managers of Swiss firms subject to friendly takeovers engage in an opportunistic earnings management during the year preceding the transaction. Earnings management is limited to the year prior to the transaction. Results presented in Table IV show that discretionary accruals for target firms as well as the control sample are non significant in the year −2 prior to the offer.

Table V presents the results of the tests of equality of means between the two samples. Both parametric and non-parametric tests confirm that discretionary accruals are significantly lower for targets firms in the year prior to the tender offer. These results provide further evidence that managers of friendly takeover targets manage earnings downward in the year preceding the transaction.

In Table VI, we present the results of the regression of discretionary accruals on selected explanatory variables with a dummy variable to capture differences in earnings management practices between the two groups of firms (firm type). The results of the multivariate analysis confirm that takeover targets managers significantly manage earnings downward during the year prior to the transaction. The coefficients on the firm type variable as well as on the "Post 2000" variables are negative and significant (coef. $= -0.072$, p value < 1 percent; and coef. $= -0.044$, p value < 5 percent respectively). The relation between other control variables (Log total assets, leverage, return on equity and operating cash-flows) and discretionary accruals is not significant. These results suggest that target firms managers seem to manage earnings downward to facilitate the conclusion of the transaction to retain their positions and report better earnings during the post-acquisition period. Earnings management seems also to be more significant in "bull" market period than in "bear" period.

Our results differ slightly from prior research (Easterwood, 1998; Erickson and Wang, 1999; North and O'Connel, 2002; Guan *et al.*, 2004) which has focused mainly on the earnings management issue in the context of hostile transactions in the US. In such context, managers of firm subject to takeovers have incentives to manage earnings upward to convince target shareholders to reject the offer. However, this study's

Table IV. Discretionary accruals (DA) for target and control firms

	Target firms		Control firms	
	Year −1	Year −2	Year −1	Year −2
Mean	−0.038*	−0.017	−0.008	−0.014
Std. dev	0.091	0.094	0.083	0.099
1st quartile	−0.086	−0.046	−0.039	−0.046
Median	−0.026	−0.007	0.009	−0.019
3rd quartile	0.023	0.028	0.042	0.027

Note: *Significantly different from zero at 1 percent

Table V. Comparison of means

	Year −1			Year −2		
	Mean	Rank	Tests	Mean	Rank	Tests
DA_p	$\mu_0 = -0.008$	$R_0 = 57.34$	$t = -2.39^{***}$	$\mu_0 = -0.014$	$R_0 = 48.92$	$t = -1.04$
	$\mu_1 = -0.038$	$R_1 = 44.84$	$Z = -2.10^{**}$	$\mu_1 = -0.017$	$R_1 = 46.98$	$Z = -0.34$

Notes: Subscript 0 corresponds to control firms, and subscript 1 to target firms. The t values and Z values are those resulting from the test (i.e. respectively the Student t test and Mann-Whitney U test) of the hypothesis that there is no difference between target and control firms. and R denote respectively the mean and the rank of each sub-sample

Variables	Parameter estimates	Std. error	t-stat	Pr > $\lvert t \rvert$
Intercept	− 0.010	0.073	0.130	0.897
Firm type	− 0.072	0.019	− 3.889	0.001**
Log (total assets)	0.008	0.029	0.294	0.770
Debt/equity	− 0.007	0.013	− 0.524	0.602
Return on equity	− 0.016	0.040	− 0.392	0.696
Operating cash flows	− 0.113E-03	0.117E-04	− 0.962	0.339
IAS/IFRS	0.022	0.020	1.071	0.288
Post 2000	− 0.044	0.019	− 2.370	0.021*
Adjusted $R^2 = 14.9$ percent				
$F-$ value $= 2.94^{**}$				

Notes: *, ** Significant at the 10 percent and 5 percent respectively. Firm type equals to 1 for target takeover firms and 0 for the control group

$$DA_i = \alpha_1 + \alpha_2 \log \begin{pmatrix} \text{Total} \\ \text{assets} \end{pmatrix}_i + \alpha_3 \begin{pmatrix} \text{Debt to} \\ \text{equity} \end{pmatrix}_i + \alpha_4 \begin{pmatrix} \text{Return} \\ \text{on equity} \end{pmatrix}_i + \alpha_5 \begin{pmatrix} \text{Operating} \\ \text{cash-flows} \end{pmatrix}$$
$$+ \alpha_6 \begin{pmatrix} \text{Firm} \\ \text{type} \end{pmatrix}_i + \alpha_7(\text{IAS})_i + \alpha_8(\text{Post 2000})_i + \varepsilon_{i,j}$$

Table VI. Regression results of variables affecting discretionary accruals

findings are similar to Eddey and Taylor (1999) who report evidence of downward earnings management by Australian takeover targets. Our results show that in the Swiss corporate control environment, where mergers are generally negotiated on a friendly basis, target managers may have different motivations to manage earnings than in a hostile corporate control environment.

6. Conclusion

This study examined earnings management by takeover targets in Switzerland. The Swiss setting offers an interesting context in which to examine this issue. Switzerland has specific characteristics such as an accounting regulation which prescribes few and rather flexible guidelines (Cormier *et al.*, 2000) leaving managers great discretion in terms of accounting policy. Like other European countries, corporate ownership is concentrated in Switzerland (Faccio and Lang, 2002) and the corporate control environment is friendly. This study contributes to the existing research on earnings management during corporate control contests.

Our findings document that managers of friendly takeover targets in Switzerland manage earnings downwards in the year preceding the transaction. These results differ from those of prior US studies which have examined earnings management by hostile takeover target managers (Easterwood, 1998; North and O'Connel, 2002; Guan *et al.*, 2004). In a hostile corporate control environment, target managers are motivated to manage earnings upward in the period preceding the transaction. This study's results suggest that in a friendly corporate control environment target managers may have different motivations to manage earnings. These results highlight the importance of the distinction between hostile and friendly transactions in studies examining accounting choices by firms implicated in M&A transactions.

Notes

1. The general accounting rules and standards approved for stock companies in Switzerland are set out in articles 662 to 673 of the CO.
2. The Swiss GAAP RPC are the standards published by the Foundation for Recommendations Concerning the Presentation of Accounts (FER: Fachkommission für Empfehlungen zur Rechnungslegung) created in 1984. The FER is the Swiss accounting standards body and is modelled on the American FASB (Financial Accounting Standards Board). Its mandate is to make recommendations to improve the quality and comparability of financial statements and to harmonize Swiss accounting practices with international standards. FER standards are essentially concerned with consolidated accounts.
3. Numerous Swiss listed companies voluntarily adopted the IAS/IFRS for financial reporting purposes during the 1990s (Dumontier and Raffournier, 1998).
4. Wright and Guan (2004) have also examined three specific accounting policy choice for a period of three years to MBOs and found evidence that management of firms involved in MBOs make more income increasing accounting choices than a sample of non-MBO firms.
5. Dahya and Powell (1998) examined a sample 262 takeovers in the UK during 1989-1992 and found a higher target top management turnover rate in hostile deals.
6. SDC database characterizes a deal as friendly when it is recommended by the target's board of directors.
7. We have also used the Modified Jones Model (Dechow *et al.*, 1995) to estimate discretionary accruals. The paper's qualitative conclusions remain unchanged.

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