Chapter 1 Introduction

1.1. Motivations of the study

In the early 1990s, Steinherr has indicated that there would be four major trends in international financial development, which include innovation, liberation, globalization, and de-specialization, in order to fight the growing competition in banking industry worldwide. Thereafter, many leading countries in financial market, such as Japan and United States, announced to relax limitations on the product scopes within one financial institution. Under the reform of “Big Bang” in Japan and the Gramm-Leach-Bliley Act in United States, financial institutions are allowed to conduct the sales of banking, insurance, and also stock-exchange at the same time by founding a Financial Holding Company (FHC).

In Taiwan, a series of deregulations on banking industry has been implemented since 1997. All those deregulations try to speed up the mergers and acquisitions process in Taiwan’s banking industry. Moreover, the attitude of government tends to assist financial institutions with different kinds of sales merging into one financial holding company as well. As a result, fourteen financial holding companies have been founded and the government encourages these financial holding companies to merge into a much bigger financial institution, which can compete with other foreign financial groups. As we can expect, there will be more and more mergers and acquisitions be announced in the future.

In most cases of mergers in Taiwan’s banking industry, the acquiring firm usually buys the target firm with its stocks. The number of acquiring firm shares exchanged for each share of the target firm is then determined by the
price of the acquiring firm’s stock when the merger agreement is reached, given the agreed on target firm purchase price. In other words, the higher the price of the acquiring firm’s stocks on the agreement date, the fewer the number of share that must be issued to purchase the target firm. The relation between acquiring firm stock price and shares issued in the transaction provides several incentives for managers to increase its share price before mergers. Empirically, Erickson and Wang (1999) find that acquiring firms attempt to increase their stock price prior to a stock for stock merger in order to reduce the cost of buying the target by using a sample of U.S. stock for stock mergers completed between 1985 and 1990. Hence, we examine this issue using banks’ data in Taiwan and investigate whether Taiwan banks would manipulate their earnings before mergers in order to get a more favorable price in M&As transactions.

1.2. Objectives of the study

Although there are many studies examining the behavior of banks pertinent to earnings management and the determination of exchange ratios in M&As transactions separately, limited researches have been focused on the relationship between these two topics. We have known that banks usually manipulate earnings at normal times because of the “threshold effects” in order to avoid reported losses in their income statements, but there are very few empirical researches exploring whether managers in banks would do the same thing before conducting M&As transactions. If managers indeed manipulate earnings before M&As, how does this kind of manipulation affect the dealing prices in M&As transactions?

From empirical results of our study, we expect to facilitate the correlation
existing between earnings manipulation and exchange ratio. By reviewing banks’ quarterly reports in details, we try to provide strong evidences for proving that managers in banking industry of Taiwan indeed “window-dress” earnings not only at the normal times to avoid reported losses but also before M&As transactions to make themselves much more attractive to others. We also expect to examine the differences about the level of earnings management between acquiring and acquired companies from empirical results in this paper.

Moreover, we investigate investors’ reactions toward those announcements of M&As transactions by examining abnormal returns on stock price reactions in the market after completion of M&As. From our empirical results, we provide empirical evidences on whether investors see through earnings manipulations made by managers on purpose and punish those companies through their stock prices.

1.3. Outlines of the study

In the following, we summarize relevant literatures discussing earnings management, exchange ratios, and effects on shareholders’ wealth in M&As in Chapter 2. Chapter 3 describes all the data used and hypotheses proposed in this paper. The methodologies are explained in Chapter 3. Empirical results are presented in Chapter 4. Finally, we provide our conclusions and suggestions in Chapter 5.