The Impact of Earning Management on the Market Performance of Firms Emerging from Chapter 11 Bankruptcy

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Abstract:

This study investigates the effects of firm characteristics on earnings management and the subsequent impact on long-term performance for firms that relist in the stock market after filing for Chapter 11 bankruptcy from 2000 to 2019. The results indicate that relisted firms show modest profitability improvements, evidenced by positive returns on assets and net profit margins; however, some firms may be overvalued post-relisting, warranting caution for investors. The univariate analysis reveals that blockholders do not effectively monitor earnings management, as firms with significant blockholder ownership exhibit higher levels of both accrual-based (ABCA) and real activities-based earnings management (ABRM), while institutional investors tend to limit these practices. Multivariate analysis further shows that both investor types negatively affect ABCA, although blockholders may encourage ABRM to enhance short-term performance. Additionally, successor CEOs post-bankruptcy are found to engage in more aggressive earnings management to meet market expectations. The study also finds that the duration of the restructuring process does not significantly influence earnings management, and the impact of earnings management on long-term market performance is mixed; firms with high ABCA initially underperform but may recover over time, whereas those with high ABRM consistently exhibit poorer performance across one, two, and three-year horizons, highlighting the detrimental effects of real activities-based earnings manipulation on long-term outcomes.

Keywords:

Earning management; expectational error; Chapter 11; Reorganization plan; institutional investors.