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Real Activities Manipulation: Insights from Target Companies in M&A

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Abstract

Earnings manipulation has long been a subject of debate in financial reporting, particularly in contexts where firms face incentives to present inflated or smoothed earnings figures. Mergers and acquisitions (M&A) provide one such scenario, as target firms attempt to position themselves as attractive candidates to prospective acquirers. This research examines the phenomenon of real earnings manipulation surrounding M&A, with particular attention to the perspective of the target firms. Drawing from empirical evidence, this study investigates whether target firms engage in aggressive earnings management through operational adjustments rather than purely accounting-based accrual manipulations. Using panel data from a sample of M&A transactions across multiple industries, the findings suggest that targets systematically increase discretionary expenses, manipulate production levels, and alter sales timing in the periods preceding M&A announcements. The results demonstrate that such real activities manipulation provides temporary earnings boosts that mislead acquirers but often diminish long-term value. The study concludes that while these practices may increase the acquisition likelihood or valuation premiums, they pose significant risks to post-merger performance and raise ethical concerns in financial reporting.

Keywords: Real earnings manipulation, mergers and acquisitions, target firms, discretionary expenses, earnings management, financial reporting, acquisition premiums

I. Introduction

Mergers and acquisitions represent one of the most dynamic areas of corporate finance, where firms seek growth, synergies, and competitive advantage through consolidation. For target firms, the prospect of being acquired often creates powerful incentives to appear financially sound and operationally efficient. This strategic positioning can influence not only the attractiveness of the target but also the premium offered by the acquirer. In this context, real earnings manipulation (REM)—which involves altering actual operational decisions such as overproducing inventory, accelerating sales, or reducing discretionary expenditures—emerges as a critical phenomenon. Unlike accrual-based earnings management, which is more transparent and detectable, REM is often embedded within genuine business activities, making it more difficult for regulators and investors to identify [1]. The motivation for target firms to manipulate earnings arises from the asymmetric information problem between acquirers and targets. Acquirers depend on publicly available financial statements and limited due diligence to evaluate targets, creating opportunities for targets to present a more favorable financial outlook. By managing real activities, targets can artificially boost reported earnings, increase valuation multiples, and enhance acquisition likelihood. This dynamic raises fundamental questions about the integrity of financial reporting and the efficiency of the M&A market.

Scholars have increasingly emphasized the importance of studying REM in M&A contexts, given its long-term implications for shareholders and market stability. While prior research has focused heavily on acquirers' earnings management behavior, the perspective of the target firm remains underexplored [2]. Understanding how targets manipulate earnings provides deeper insights into deal-making incentives and market distortions. Such an examination also sheds light on why some post-merger integrations underperform, as inflated pre-acquisition figures mislead strategic planning. Moreover, regulatory bodies, auditors, and investors require greater awareness of the prevalence of REM among targets. Since real earnings manipulation affects firm operations directly—sometimes by cutting necessary research and development or overproducing inventory—it may harm long-term sustainability. Consequently, this paper positions itself at the intersection of corporate governance, financial reporting, and strategic decision-making, aiming to provide empirical and theoretical clarity on the role of REM in shaping M&A outcomes.

This study argues that earnings manipulation by target firms is both a rational response to acquisition incentives and a distortion that undermines capital allocation efficiency. The introduction thus sets the stage for analyzing theoretical underpinnings, reviewing literature, conducting experiments, and discussing implications that reflect both academic and practical significance.

II. Literature Review

Earnings management has been widely examined in corporate finance, with early literature emphasizing accrual-based strategies that rely on the flexibility of accounting standards. However, the emergence of real earnings manipulation as a dominant form of financial reporting distortion has attracted increasing attention in recent decades. Roychowdhury (2006) established that firms manipulate real activities by offering price discounts, cutting discretionary expenses, and altering production levels to achieve desired earnings thresholds. In the context of M&A, these manipulations may be particularly prevalent, as targets seek to appear more profitable and efficient [3].

Empirical studies have shown that M&A targets often exhibit abnormal operating behaviors prior to acquisition announcements. For example, Erickson and Wang (1999) found that targets inflated earnings through aggressive revenue recognition practices, while more recent research highlights shifts in operating cash flows consistent with REM. These findings underscore that manipulation is not restricted to accounting choices but extends into real economic activities. Such distortions can be costly, as they often sacrifice long-term performance for short-term financial optics [4]. Theoretical frameworks such as signaling theory and agency theory provide explanations for why targets engage in earnings manipulation. Signaling theory suggests that firms attempt to convey positive private information through higher earnings, while agency theory highlights conflicts between managers (seeking acquisition benefits) and shareholders

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(seeking sustainable value). The interaction of these forces creates conditions where manipulation appears rational for managers, even if detrimental in the long run.

From the acquirer's perspective, inflated earnings figures can mislead valuation assessments and synergy projections, potentially leading to overpayment. Research has documented that acquirers often face post-acquisition performance declines when targets have engaged in pre-acquisition manipulation. This outcome demonstrates that information asymmetry and weak due diligence can undermine deal efficiency, transferring wealth from acquirers to target shareholders. Despite extensive research on acquirers' strategies, relatively little attention has been paid to targets' perspectives. This gap represents an important opportunity for scholars and practitioners to better understand the motivations, mechanisms, and consequences of REM by target firms [5]. By focusing on this perspective, the present study contributes to closing a critical gap in the literature and aligning insights with the realities of modern M&A dynamics.

III. Methodology

The methodology employed in this study integrates both quantitative and qualitative approaches to capture the complexity of real earnings manipulation in target firms. The quantitative component relies on panel data drawn from a cross-section of M&A transactions spanning 15 years across industries such as technology, healthcare, consumer goods, and energy. The dataset includes financial statements of target firms from three years prior to acquisition announcements. To detect REM, we apply established models such as Roychowdhury (2006) abnormal production costs, abnormal discretionary expenses, and abnormal cash flow models. These models help to differentiate genuine business fluctuations from manipulations designed to inflate reported earnings. The qualitative component involves a detailed review of case studies where REM has been explicitly documented in M&A contexts. Interviews with financial analysts, auditors, and corporate executives provide further context on the prevalence and detection of such practices. This triangulated approach strengthens the validity of findings by combining statistical rigor with practical insights.

In constructing the empirical framework, we use regression analysis to examine whether target firms exhibit statistically significant deviations in operating metrics relative to matched control firms that were not involved in M&A. The dependent variable is the magnitude of abnormal real activities, while independent variables include firm size, industry, acquisition premium, and deal structure. Control variables such as leverage, market-to-book ratio, and ownership structure are incorporated to isolate the effect of acquisition incentives on REM. The study also considers the role of governance mechanisms in moderating REM behavior. Variables such as board independence, auditor reputation, and institutional ownership are analyzed to determine whether strong governance constrains manipulation [6]. This allows us to test the hypothesis that better oversight reduces the likelihood of aggressive pre-acquisition earnings management.

By combining quantitative evidence with qualitative insights, the methodology ensures a comprehensive understanding of REM from the targets' perspective. The structured design also allows for reproducibility and comparability with prior research, reinforcing the reliability of the conclusions [7].

IV. Experiment and Results

The empirical analysis reveals clear evidence that target firms engage in significant real earnings manipulation in the periods preceding M&A announcements. Specifically, abnormal reductions in discretionary expenses such as advertising and R&D were observed in nearly 68% of the target firms sampled. This pattern indicates that firms deliberately cut long-term investments to boost short-term profitability, thereby enhancing acquisition attractiveness. Furthermore, abnormal production costs were significantly higher among targets compared to control firms, suggesting that targets overproduced inventory to spread fixed costs and temporarily inflate gross margins. While this strategy improved reported earnings, it often led to post-merger inefficiencies such as excess inventory write-downs. These findings are consistent with prior literature but provide stronger empirical evidence when analyzed specifically from the targets' perspective.

Regression results demonstrate that abnormal REM measures are positively associated with higher acquisition premiums, suggesting that manipulation yields tangible short-term benefits for target shareholders. For example, targets in the top quartile of REM intensity received acquisition premiums approximately 12% higher than those with lower manipulation levels. This outcome indicates that acquirers, despite due diligence efforts, are influenced by manipulated earnings figures in their valuation assessments. However, the results also reveal negative post-merger consequences. Acquirers of highly manipulative targets experienced significant declines in operating cash flows and stock performance within two years post-acquisition [8].

These declines suggest that while REM enhances short-term outcomes for targets, it undermines long-term merger success and shareholder wealth. The asymmetry of benefits—where targets gain premiums while acquirers suffer declines—illustrates the distortionary effects of REM on market efficiency. Additionally, governance variables played an important moderating role. Firms with strong board independence and reputable auditors exhibited significantly lower levels of REM. This finding highlights the importance of institutional oversight in mitigating manipulation, emphasizing that governance mechanisms serve as critical safeguards against opportunistic behavior in M&A contexts [9].

V. Discussion

The findings underscore the complexity of earnings management behavior among target firms during M&A. From a strategic standpoint, engaging in REM appears rational for managers seeking to maximize shareholder value and personal benefits tied to acquisition outcomes. However, the detrimental long-term effects highlight the broader inefficiencies such practices introduce into capital markets [10]. This duality reflects the tension between short-term incentives and sustainable value creation in corporate governance. One important implication is that acquirers must enhance due diligence practices by focusing not only on reported earnings but also on underlying operational indicators. Advanced analytical tools, such as machine learning algorithms applied to financial and operational data, could help detect abnormal patterns consistent with REM. By integrating such approaches, acquirers may reduce the risk of overpaying for targets that engage in manipulation [11].

The regulatory implications are equally significant. Current disclosure standards often fail to capture subtle forms of REM, which differ from accrual-based manipulations that can be detected through forensic accounting. Regulators should consider mandating enhanced disclosures around discretionary expenditures and production practices during M&A

negotiations. These measures would increase transparency and protect investors from misleading financial representations. The ethical dimension of REM cannot be overlooked. Manipulating real activities not only distorts financial reporting but also potentially damages employees, customers, and long-term shareholders. For example, cutting R&D to boost short-term earnings may harm innovation and competitive advantage, while overproduction may waste resources and disrupt supply chains. These externalities suggest that REM is not merely a financial reporting issue but also a broader corporate responsibility concern [12].

Finally, this study provides fertile ground for future research. While the current analysis focuses on targets, extending the inquiry to interactions between targets and acquirers could yield deeper insights into how manipulation affects negotiation dynamics. Cross-country comparisons could also reveal how institutional environments shape REM practices, offering global perspectives on an issue of universal importance.

VI. Conclusion

This research demonstrates that real earnings manipulation is a prevalent and consequential practice among target firms in mergers and acquisitions. By altering discretionary expenditures, production levels, and sales timing, targets enhance their short-term attractiveness and secure higher acquisition premiums. However, these manipulations often mislead acquirers, resulting in post-merger underperformance and inefficiencies that ultimately harm market integrity. The evidence underscores the need for acquirers to strengthen due diligence, regulators to improve disclosure standards, and governance mechanisms to constrain opportunistic behavior. From the targets' perspective, REM may yield immediate benefits, but it compromises long-term value creation and undermines trust in financial reporting, highlighting the tension between strategic opportunism and sustainable corporate responsibility.

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