RELATED PARTY TRANSACTIONS AND STOCK MARKET REACTION TO SEASONED EQUITY OFFERINGS ANNOUNCEMENT

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Abstract
Seasoned equity offerings (SEOs) provide a direct incentive for issuing firms to manage reported earnings. Current shareholders of the SEO firm can benefit if intentional earnings management would affect market perceptions of the firm’s value. Therefore, managers have considerable incentives to exercise their discretion, which can contribute to the inflation of reported earnings. Prior research indicates that issuing firms do engage in earnings management before SEO announcement (Ching, et al, 2006). This study argues that SEO firms can manage reported earnings by manipulate real activities (e.g., Gunny, 2005; Zang, 2006; Roychowdhury, 2006). Managers have incentives to inflate reported earnings to reduce the level of underpricing in the SEOs. They may mislead investors to overestimate the value of the firm and be extremely optimistic about the issuer’s prospects. In other words, outside investors may be misled by the high earnings reported in the pre-SEO period (Teoh, Siew Hong, Ivo Welch, and T. J. Wong, 1998), and this earnings manipulation can be done through related-party transaction. In this study, I examine whether abnormal RPTs in the pre-SEO period is correlated with the SEO announcement abnormal stock returns. This study analyze the sample of firms listed in Taiwan during 2000 to 2014 to investigate how SEO firms manipulate reported earnings via related party transactions. Based on 596 SEOs sample, the evidence suggests that SEOs firms experience significant negative abnormal returns on announcement days. The results further suggest that abnormal related party sales in the pre-SEO period have a negative impact on the SEO announcement returns. The findings remain the same even after considering the endogenous issues. Finally, the evidence suggests that better quality of corporate governance can reduce the use of abnormal related party sales.

Keywords — Related party transaction, Seasoned equity offerings, Abnormal returns