Journal of Accounting Research

DOI: 10.1111/1475-679X.12247
Journal of Accounting Research
Vol. 57 No. 1 March 2019
Printed in U.S.A.

CHICAGO BOOTH

International Mergers and Acquisitions Laws, the Market for Corporate Control, and Accounting Conservatism

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Received 12 October 2015; accepted 5 October 2018

ABSTRACT

Exploiting the staggered enactment of country-level mergers and acquisitions (M&A) law as an exogenous increase in corporate takeover threat, this paper examines how a disciplinary market for corporate control affects accounting conservatism. Following M&A law adoption, we find increased accounting conservatism, with more pronounced effects in countries with weak shareholder protection and in those experiencing larger growth in takeover activity. Further analysis reveals that elevated takeover threats increase conservatism through changes in capital structure and investment decisions as well as improvements in board monitoring. Our findings highlight the

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Accepted by Philip Berger. We appreciate the helpful comments of an anonymous referee, Felipe Bastos Gurgel Silva, Sudipta Basu, Jeff Boone, Jere Francis, Matt Glendening, Weishi Jia, Xi Li, Valeri Nikolaev, K.K. Raman, Abdel-Khalik Rashad, Marco Trombetta, John Wang, Holly Yang, and participants at the 2016 AAA Annual Meeting, 2016 EAA Annual Meeting, 2016 FARS Midyear Meeting, Singapore Management University, and The University of Texas at San Antonio. An online appendix to this paper can be downloaded at https://research.chicagobooth.edu/arc/journal-of-accounting-research/online-supplements.

importance of the market for corporate control in shaping financial-reporting outcome.

JEL codes: G34; K22; M41

Keywords: international M&A laws; takeover threat; accounting conservatism; corporate governance

1. Introduction

Economic theory on the market for corporate control indicates that the threat of takeover is an important governance mechanism, constraining managers and directors from undertaking actions contrary to shareholder interests (Manne [1965], Fama and Jensen [1983], Safieddine and Titman [1999]). The disciplinary effect arising from potential takeover activity can be particularly relevant for nations aiming to bolster capital market growth through enhanced corporate governance (Nenova [2006], Bris and Cabolis [2008]). A separate stream of research posits that accounting conservatism, by imposing timelier recognition of economic losses relative to gains in financial statements, can serve as a viable governance mechanism that limits managerial opportunism (Basu [1997], Watts [2003], Ball and Shivakumar [2005]). While the market for corporate control and accounting conservatism are intricate parts of the nexus of a firm's governance structures, the precise channels are not well understood, particularly in countries where institutions in place need not necessarily offer strong protection for investors.

In this paper, we study the effect of market for corporate control on accounting conservatism in a cross-country setting and evaluate several economic explanations. Our identification strategy exploits variations in takeover threats firms face due to the staggered adoption of mergers and acquisitions (M&A) laws in their home countries. During our sample period, many countries passed legislation aimed at promoting takeover activity in the domestic markets by reducing legal barriers to M&A transactions and facilitating an orderly process of changes in corporate control (Nenova [2006]). In many ways, these regulatory shocks offer an ideal setting for our analysis. They alleviate reverse causality concerns, as firm-specific level of accounting conservatism is unlikely to have an impact on country-level M&A laws. Moreover, exploiting the staggered passage of M&A law in different countries allows us to disentangle the effect of M&A law from regulatory and macroeconomic events that could otherwise bias the estimation.

Using a panel data set of more than 70,000 publicly listed firms in 34 countries from 1992 through 2005 and employing Basu's [1997] measure of asymmetric timeliness of loss recognition, we show that enacting M&A law leads to greater conservatism in firms' financial reports. This finding is robust to two alternative regression specifications: the first with a difference-in-differences (DiD) estimator, which compares changes in the degree of accounting conservatism for firms subject to M&A law (the

treatment group) to firms not subject to M&A law (the control group); and second, utilizing an event-study framework, which traces the dynamics of conservatism over a tight four-year window around the promulgation of each M&A law. Our results are also robust to (1) inclusion of treatment-specific time trends that absorb any differential trends between treatment and control groups in the DiD design, (2) alternative measures of accounting conservatism, and (3) alternative matching schemes that pair treated firms with observationally similar control firms.

We identify two plausible mechanisms through which an increased takeover threat evokes greater conservatism. First, firm managers facing increased takeover pressure have an incentive to increase leverage and decrease capital spending to defend against unwanted takeover bids. These real activities can, in turn, alter firms' financial-reporting behavior (the "real effects channel"). This view draws on the large capital structure literature, which reports that in the face of increased takeover threat, firm management increases leverage to credibly commit to shareholder wealth (Jensen [1986], Zwiebel [1996]) and, consequently, make it more difficult for bidders to complete the takeover (Berger, Ofek, and Yermack [1997], Noaves [2002]). In addition to boosting the proportion of debt in the firm's capital structure, the incumbent management is positioned to cut inefficient capital investments, preempting the bidder's wealth gain potentially arising from the takeover (Hendershott [1996], Safieddine and Titman [1999], Servaes and Tamayo [2014]). Increases in leverage and reductions in wasteful capital spending often accompany timelier loss recognition, because accounting conservatism reduces informational friction and agency conflict underlying corporate restructuring (Bushman, Piotroski, and Smith [2011], Garcia Lara, Garcia Osama, and Penalva [2016]).

Second, an active takeover market can motivate boards of directors, who might have gotten cozy with management, to step up monitoring efforts, as the board itself could be dismissed by a successful acquirer who views its monitoring decisions to be inadequate (Fama and Jensen [1983], Hirshleifer and Thakor [1998]). In theory, since directors do not fully internalize the benefits of costly monitoring, they tend to avoid the effort unless there is external impetus, such as a takeover bid (Shleifer and Vishny [1997], Kumar and Sivaramakrishnan [2008]). Lel and Miller [2015] find that directors are more likely to lose board seats following corporate control events and that country-level M&A law enactment improves directorial oversight. Ahmed and Duellman [2007] show that directors characterized as more vigilant monitors, such as outside directors owning a larger share of the firm, prefer management to report more conservatively. The rationale is, by imposing more stringent and verifiable requirements for economic gains relative to losses, conservatism drives managers to be more forthcoming about adverse news, enabling directors to intervene sooner in poorly performing projects and better evaluate executive compensation policies. Conceivably, as greater takeover threats create incentives for directors to

monitor managers more closely, demand for conservatism will increase (the "board monitoring channel").[1]

We perform several analyses to evaluate whether our results are aligned with the theoretical predictions of the aforementioned channels. Following M&A law enactment, we find a 3.3-percentage-point increase in financial leverage and a 9.3-percentage-point decline in capital spending for treated firms relative to control firms. Compared to their pre-enactment mean values, leverage increases by 14% and capital spending decreases by 27%. Additional evidence shows that the reduction in capital spending stems from firms curtailing inefficient projects and investing closer to a first-best level. Linking the changes in real activities to the changes in conservatism, we find that the observed increase in conservatism is greater when firms increase leverage and curtail capital expenditures more. Together, these findings point to adjustments in corporate capital structure and investment decisions as a plausible economic channel by which M&A law enactment increases accounting conservatism.

Consistent with the conservatism effect also running through the board monitoring channel, we find the greatest increase in conservatism following M&A law enactment among countries where chief executive officer (CEO) pay to firm performance sensitivity exhibits the greatest increase. CEO pay-performance sensitivity reflects a board's monitoring effectiveness, since permissive boards are more likely to shield managers' wealth from the effects of poor performance, allowing managers to extract rents from shareholders (Jensen and Murphy [1990], Correa and Lel [2016]). We also find increased conservatism more salient in countries where corporate laws and legal regimes are more lenient with entrenched management and boards. These are precisely the countries standing to benefit most from board monitoring improvement, because alternative firm-level governance mechanisms can be either ineffective or prohibitively costly in these countries (Doidge, Karolyi, and Stulz [2007]).

A remaining concern is that macroeconomic fluctuations or contemporaneous regulatory changes in a country could drive both M&A law passage and individual firms' reporting choices. We address this concern in three ways. First, we show that M&A law's effects on conservatism are greater when it more successfully achieved its intended outcome of stimulating takeover activity. Second, we corroborate the sensitivity of our results with respect to contemporaneous regulatory events by controlling for a number of country-level regulatory developments, such as insider trading law enforcements and short-selling regulations. Results are also robust to

[1] In the context of a disciplinary market for corporate control, the real effects channel and the board monitoring channel are unlikely to be mutually exclusive but rather are intrinsically connected with each other. Major corporate restructuring and investment decisions need approval by boards of directors, and there are also good reasons to believe that directors, in an attempt to improve their monitoring, are likely to demand that value-enhancing corporate changes be made by the management.

including "country × year" fixed effects that control nonparametrically for correlated time-specific shocks at the country level. Last, we conduct placebo tests by randomly assigning fictitious M&A law enactment events to control firms and reestimate the main specification. Simulations confirm that our results are unlikely to be driven by spurious correlations.

We check whether the conservatism effect of M&A law enactments is due to increased agency conflict between shareholders and debtholders triggered by takeover threat. Prior literature suggests that, while the market for corporate control benefits shareholders, creditors could suffer from corporate restructuring prompted by elevated takeover threat and actions shareholder-friendly managers could undertake to expropriate wealth from debtholders (Jensen and Meckling [1976], Cremers, Nair, and Wei [2007]). To the extent that conservatism mitigates agency costs of debt by placing timely constraint on value-expropriating actions (Watts [2003], Nikolaev [2010]), debtholders could demand greater accounting conservatism in response to heightened takeover vulnerability. One testable prediction of this channel is, firms in newly established M&A law regimes will receive worse borrowing terms due to the increased likelihood of wealth transfer from debtholders to shareholders. Using data on syndicated bank loans from DealScan, we find that, relative to loans issued to control firms, loans issued to treated firms do *not* carry higher interest rates or include more covenants after the passage of M&A laws, suggesting that agency cost of debt is unlikely to explain the conservatism effect.

To complete our analyses, we explore specific accounting practices that could contribute to the overall increase in financial-reporting conservatism. We find that M&A law passage is associated with increased uncollectible accounts receivable provisions and special-item losses, including asset write-downs and intangible-asset impairments. We also find evidence of an increase in accrued expenses as well as selling, general and administrative expenses. These changes are consistent with firms reporting more conservatively in the presence of an increased takeover threat.

Our study makes several contributions to the literature. First, we contribute to prior research exploring the interactions between corporate governance structures and financial reporting timeliness (Bushman et al. [2004], Ahmed and Duellman [2007], LaFond and Watts [2008], Garcia Lara, Garcia Osama, and Penalva [2009], Armstrong, Guay, and Weber [2010]). Employing an *exogenous* shock to the takeover pressures firms face due to country-level M&A law adoption, we sidestep endogeneity issues common in prior work and document the impact of takeover threat on accounting conservatism.

Second, our study contributes to the burgeoning literature examining the economic consequences of enacting takeover regulations globally. Nenova [2006] shows that takeover laws facilitate an orderly process of changes in corporate control as well as fair treatment of all existing shareholders. Lel and Miller [2015] find that enacting international M&A laws increases the sensitivity of CEO turnover to firm underperformance, especially in

countries with weaker legal institutions. Glendening, Khurana and Wang [2016] find that M&A law enactments decrease firms' need to issue dividends by enhancing monitoring intensity on managers. Balachandran et al. [2017] show that stock price crash risk and earnings management decrease following the passage of the international M&A laws, which they attribute to increased takeover threat constraining management's bad news hoarding behavior.[2] We advance this line of inquiry by showing that M&A law enactments increase accounting conservatism in firms' accounting reports.

Third, our paper is closely related to several recent studies examining the impact of U.S. takeover legislation on accounting conservatism, which to date have yielded mixed evidence. Jayaraman and Shivakumar [2013] show that firms exhibit a higher degree of asymmetric timeliness of loss recognition after state-level antitakeover laws pass in the United States (implying a lower probability of takeover). They attribute the effect to antitakeover laws exacerbating agency cost of debt and thereby increasing debtholders' demand for conservatism. Callen, Guan, and Qiu [2014] find accounting conservatism increases after the passage of state antitakeover laws, proposing that firms substitute a more conservative financial reporting policy for weakened external governance. In Contrast, Cheng, Duru, and Zhao [2017] document a negative relation between accounting conservatism and state antitakeover laws. This effect, Cheng, Duru, and Zhao [2017] argue, is due to antitakeover laws decreasing shareholder-debtholder conflicts and, consequently, reducing debtholders' demand for conservatism.

There are important differences that distinguish our work from these studies. First, we identify the effect of the takeover market on accounting conservatism for a broad set of non-U.S. countries in which the corporate governance landscape and institutional environments, and thus firm-level responses to the disciplinary market for corporate control, are likely to be markedly different from those in the United States (La Porta et al. [1998], Aggarwal et al. [2009]). Second, our paper provides a first attempt at linking changes in financial-reporting conservatism to the real effects caused by M&A laws, an important mechanism unaddressed by prior work. Third, while the state business combination laws, the focus of many U.S. studies, were a single class of various state-level takeover statutes, the international M&A laws in our paper contain a broad spectrum of takeover provisions including, among others, the squeeze-out rules mandated by the *Takeover Act* in Austria and the board neutrality rule provisioned in the *Takeover Panel Act* in Ireland. This distinction is important, as recent studies show that the state-level business combination laws might not have had a discernible impact on takeover activity and corporate policies, casting doubt on the

[2] In contrast, Sul [2017] finds that the enactment of international M&A laws designed to promote takeover activity is associated with increased earnings management (abnormally high accruals, small positive earnings, and poor accruals quality) and decreased transparency (reduced analyst forecast accuracy and greater forecast dispersion). Sul attributes the finding to an active takeover market heightening CEO job security concerns.

effectiveness of using the business combination laws alone in proxying for governance quality (Cain, McKeon, and Solomon [2017], Karpoff and Wittry [2018]). Thus, international M&A laws, encompassing a more diverse set of statutes designed to reduce frictions in M&As, allow us to gain new insights into the effect of the market for corporate control.

The remainder of our paper is organized as follows. Section 2 provides institutional background on the international M&A laws, reviews the related literature, and develops our testable prediction. Section 3 discusses the sample and research design. In section 4, we present the empirical results. Section 5 concludes the paper.

2. *Institutional Background and Hypothesis Development*

2.1 INTERNATIONAL M&A LAWS AND INCREASED TAKEOVER THREAT

The late 1990s and early 2000s witnessed a wave of takeover legislation passed by countries that aimed to foster corporate control activity and invigorate industrial growth (Berglof and Burkart [2003], Goergen, Martynova, and Renneboog [2005]). Much of the impetus for these takeover regulations came from the fact that corporate restructurings, especially those in mature and retrenched sectors of the economy, had been difficult to achieve, due to the lack of a legal framework governing control market activity coupled with ineffective shareholder protection during takeover transactions. Critically, legal systems concerning key aspects of corporate control transactions, including those governing the allocation of takeover gains between the bidder and target shareholders, were inadequate and elusive. Such regulatory opacity surrounding the takeover market discouraged (more capable) outside management in contesting for corporate control, trapping domestic firms under inefficient management and eroding their competitive strength (Holmstrom and Kaplan [2001]).

Appendix A reports specific provisions contained in national takeover laws passed from 1995 through 2002. A principal objective of these laws is to establish a clear set of rules and legal procedures for the bidding process, thereby reducing the costs and inefficiencies associated with the takeover mechanism (Gordon [2003], Nenova [2006]). For example, both Austria's *Takeover Act* and Indonesia's *Government Regulation No.27/1998* introduced a numerical threshold of control rights (30% and 25%, respectively), beyond which the bidder in a takeover transaction will be mandated to publicly disclose the purpose for the accumulation of the share stake. Some M&A laws, such as Malaysia's *Code on Takeovers and Mergers*, imposed board neutrality that prohibited boards of directors from taking actions that frustrate takeover bids. M&A laws promulgated a combination of legal provisions that, in practice, aimed to strike a fine balance between easing the financial/regulatory burden of the bidder in completing a takeover transaction (e.g., the squeeze-out rule) and protecting minority shareholder interests from wealth expropriation by outside bidders (e.g., the

mandatory-bid rule). As an intended consequence, the enactment of national takeover laws has proven to evoke a sizeable increase in takeover activity and attendant improvement in aligning the interests of management and shareholders in enacting countries (Lel and Miller [2015]).[3]

In comparison to U.S. state takeover laws, the international M&A laws in our sample have provisions similar to the fair price laws in Connecticut, the cash-out provisions in Delaware, and the takeover disclosure law adopted in Pennsylvania. However, international M&A laws differ from U.S. state takeover laws in several important aspects. Chief among them is the difference in degree of freedom allowed by the two sets of laws to corporations in adopting defensive measures against a takeover bid. While antitakeover mechanisms such as poison pills or staggered boards are widespread and generally accepted in the United States, they are often prohibited in countries outside the United States (e.g., Austria and Brazil). International M&A laws also contain specific provisions that are unique to the countries' institutional environment and legal structures. For example, some countries introduce significant tax benefits to acquirers and new types of mergers, including whale-minnow mergers, cash-out mergers, and cross-border mergers (as in Taiwan), while some countries passed laws that define shareholder rights and firm directors' duties subject to a contest for control (as in Malaysia). Some simplify government approval procedures and reduce bureaucratic red tape (as in the Philippines), and some eliminate certain takeover defenses and unequal treatment of existing shareholders in terms of the value distribution (as in India).

2.2 HYPOTHESIS DEVELOPMENT

Why would an active market for corporate control, invigorated by the passage of M&A law, affect accounting conservatism? We present two potential channels through which such an impact could manifest itself. The first channel builds on the financial economics literature, which shows that, in the presence of a takeover threat, managers adjust corporate decisions strategically to defend against unwanted takeover attempts. The theoretical framework underlying this literature, as developed in Grossman and Hart [1982], Jensen [1986], and Noaves [2002], formalizes the market for corporate control as an external governance mechanism that incents self-interested managers to maximize shareholder value. In

[3] We confirm the positive effect of M&A law enactment on takeover activity in a regression framework. We regress takeover intensity (the total number of takeover transactions divided by the number of firms in the country) on the binary indicator for M&A-affected country years and a set of country-level control variables, including the natural log of GDP per capita, stock market capitalization-to-GDP, private credit-to-GDP, changes in exchange rate relative to U.S. dollars, a binary indicator set to one for countries with common law origin, and zero otherwise, and the anti-self-dealing index from Djankov et al. [2008]. The point estimates imply that, holding other things fixed, the enactment of an M&A law leads to a 25.4% increase in takeover intensity.

these models, management's underperformance or rent-seeking activities entice outside parties to launch a takeover bid for the organization. In response to an increased takeover threat, managers can opt to lever up the firm's capital structure as a credible commitment to shareholder wealth. As Jensen [1986] and Zwiebel [1996] argue, interest and principal payments on debt, coupled with bankruptcy or distress-related costs, restrict managers' proclivity for inefficient activities that confer private benefits. Managers under takeover pressure can also abandon unproductive investments, which decrease the bidder's potential gain from takeover (Hendershott [1996], Berger and Ofek [1999]). The risk of control challenges is effectively eliminated if management can commit to policies that promise investors more value than their next-best alternatives (Morellec [2004]). Consistent with the theory, empirical work on the U.S. takeover market shows that firms facing heightened takeover pressures adjust their capital structure and investment policies as defense strategies (Denis and Denis [1993], Berger, Ofek, and Yermack [1997], Safieddine and Titman [1999], Servaes and Tamayo [2014]).

We anticipate, when countries pass M&A laws, their enactment will lead to firm-level changes in financing and investment decision making, which can create a knock-on effect on the degree of accounting conservatism in firms' financial reports. This prediction draws on prior literature in the economic consequences of accounting conservatism. Watts and Zimmerman [1986] and Watts [2003] posit that accounting conservatism facilitates corporate debt financing by providing creditors with timely lower bound estimates of firm performance, reducing moral hazard–related costs. Empirical work illustrates the benefits of accounting conservatism in reducing friction inherent in the debt-financing process (e.g., Ahmed et al. [2002], Ball and Shivakumar [2005], Nikolaev [2010], Aier, Chen, and Pevzner [2014]). The extant research also shows that, by requiring timelier recognition of economic losses relative to gains, accounting conservatism constrains managers' ability to overinvest (Francis and Martin [2010], Garcia Lara, Garcia Osama, and Penalva [2016]). Conceivably, as firms ratchet up financial leverage and cut excessive capital investment to thwart takeover attempts, a concomitant increase in firm financial-reporting conservatism will occur. The key insight is that changes in accounting conservatism do not occur in isolation; they arise as a viable device facilitating the kind of strategic corporate restructuring management undertakes in the presence of takeover pressure. We label this channel as the "real effects channel."

Second, just as an active takeover market disciplines management, enhanced takeover pressure can push boards of directors, ostensibly guardians of shareholder rights but who might have gotten cozy with management, to step up monitoring efforts (Fama and Jensen [1983], Hirshleifer and Thakor [1998]). The reason is, were the firm to be taken over, the successful acquirer could dismiss board members if their monitoring decisions are deemed inadequate. As Jensen and Ruback [1983] propose,

when corporate internal control mechanisms operating through the board of directors fail to discipline management, external control mechanisms, such as the takeover market, will step in and bring about desired changes. Hirshleifer and Thakor [1998] model the so-called "kick-in-the-pants" effect, whereby the threat of takeover forces the board to discipline poorly performing managers; otherwise the board may have to pay a "personal price" for being lenient. In support of the positive effects of corporate control market on board monitoring, Lel and Miller [2015] show greater firm-level directorial oversight, measured by improvements in executive turnover-performance elasticity, after the firm's home country adopts M&A laws.

There is a consensus view in the accounting literature that conservative financial reporting allows directors to discipline management and reduce deadweight losses associated with agency problems (Beekes, Pope, and Young [2004], Ahmed and Duellman [2007], Garcia Lara, Garcia Osama, and Penalva [2009]).[4] By enforcing asymmetrically timely loss recognition, accounting conservatism reduces managers' ability and incentives to overstate returns from value-reducing projects and to extract excessive compensation (Watts [2003], LaFond and Roychowdhury [2008]). Additionally, provisions of lower bound estimates on earnings and asset values inform directors about any downward shift in firm performance, so they can intervene quickly to take remedial actions. To the extent that directors monitor managers more intensely following the enactment of M&A laws, as demonstrated in Lel and Miller [2015], their demand for conservatism is expected to increase. We call this channel the "board monitoring channel."

The above discussion leads to the following hypothesis:

H1: Passage of M&A law leads to a greater degree of accounting conservatism in firms' financial statements, ceteris paribus.

Several countervailing factors could be at work that offset the predicted increase in conservatism following M&A law enactment. It is possible that the fear of takeover can cause managers to behave myopically and sacrifice long-term value in pursuit of short-term gains. For example, managers fearful of losing their jobs and related perks might quickly record good news in financial statements, even when such news is unlikely to materialize, while delaying recognition of bad news. Managers also have incentive to favorably skew reported performance when a takeover is unavoidable, to extract

[4] Ahmed and Duellman [2007] study the relation between board monitoring and conservatism. They find a positive relation between the percentage of outside director ownership and accounting conservatism, suggesting that board members demand conservatism to discipline managers. Beekes, Pope, and Young [2004] use U.K. data and find that firms with a higher proportion of outside directors recognize bad news in earnings on a timelier basis. Garcia Lara, Garcia Osama, and Penalva [2009] use a combination of internal and external governance proxies (which include firms' board composition and board effectiveness) and find that firms with stronger governance exhibit a higher degree of accounting conservatism.

a higher bidding price. This argument, however, requires that the target foresees a potential buyout and has sufficient time to manage earnings and that the acquirer is unable to discern the target's earnings management (Erickson and Wang [1999], McNichols and Stubben [2014]). Overall, these alternative scenarios add tension to our prediction and, if valid, make it more difficult for us to find a positive influence of M&A law enactment on accounting conservatism.

3. Sample and Research Design

3.1 SAMPLE AND DATA

We start with a list of 12 countries that initiated M&A laws over the period 1995 through 2002 compiled by Lel and Miller [2015], who collect information on M&A law enactment from various sources including existing studies on takeover laws (e.g., Nenova [2006]), financial law publications (e.g., *International Financial Law Review*), and national regulatory websites.[5] We exclude countries that passed takeover laws after 2004 to ensure that our estimates are not confounded by passage of the European Union's Takeover Directive in 2004 and the worldwide adoption of International Financial Reporting Standards (IFRS) in 2005. Following Lel and Miller [2015], we identify 22 countries that never passed M&A law over the sample period as a control group. The sample period starts three years before the earliest enactment of M&A law when Sri Lanka passed *Company Takeovers and Mergers Code* in 1995, and ends three years after Taiwan passed *Business Mergers and Acquisitions Act* in 2002. We obtain accounting and stock price information for publicly listed, nonfinancial firms (i.e., SIC codes 6000–6999 are excluded) from Compustat Global. The main sample consists of 71,604 firm-year observations for 11,404 firms from 34 countries.

Table 1 reports the sample composition by country and lists the year in which a country passed its M&A law. Among the 12 countries that passed an M&A law, Malaysia contributes the largest number of firm-year observations at 5,221 (791 unique firms), closely followed by Germany, which has 5,191 firm-year observations (750 unique firms). Sri Lanka, on the other hand, provides the smallest number of firm-year observations at 135 (54 unique firms) among M&A law–enacting countries. Turning to nonenacting countries, the largest and the smallest number of observations come from Japan at 28,100 (3,191 unique firms) and Zimbabwe at 72 (16 unique firms), respectively.[6]

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[5] Table A1 in Lel and Miller [2015] reports the name and enactment year of M&A laws, as well as the sources used to identify the information. We discuss specific provisions of each M&A law in Appendix A.

[6] In light of the concern that countries with more than 5,000 observations per country can drive the cross-country regression results, we submit our results to two sensitivity checks. First, we test the robustness of our results to a country-year panel specification and report the results

TABLE 1
Sample Distribution by Country

Country	Number of Observations	Number of Firms	M&A Law Year
Argentina	327	60	None
Austria	727	105	1998
Brazil	1,252	215	None
Chile	698	118	2000
China	5,055	1,281	None
Colombia	98	17	None
Czech Republic	122	28	None
Denmark	1,010	149	None
France	4,920	756	None
Germany	5,191	750	2002
Greece	764	188	None
Hungary	141	23	None
India	2,116	596	1997
Indonesia	1,584	238	1998
Ireland	491	68	1997
Israel	409	92	None
Japan	28,100	3,191	None
Korea	2,802	520	None
Luxembourg	122	22	None
Malaysia	5,221	791	1998
Mexico	570	99	None
New Zealand	612	109	2001
Norway	1,036	172	None
Pakistan	527	121	2000
Peru	190	39	None
Philippines	809	128	1998
Poland	506	119	None
Portugal	385	68	None
Sri Lanka	135	54	1995
Taiwan	2,792	809	2002
Thailand	2,306	365	None
Turkey	420	79	None
Venezuela	94	18	None
Zimbabwe	72	16	None
Total	71,604	11,404	

This table presents the sample distribution by country. It shows the number of observations, the number of unique firms and the enactment year of M&A law for each country. Countries in bold are those that enacted M&A law during the sample period. There are 71,604 firm-year observations and 11,404 unique firms in the final sample.

3.2 RESEARCH DESIGN

To identify the effect of M&A law adoption on accounting conservatism, we estimate a DiD model based on Basu [1997] piecewise linear regression of accounting income on stock returns, which captures the asymmetric timeliness of loss recognition (Beaver and Ryan [2005], Ball, Kothari, and Nikolaev [2013a]). The regression takes the following form:

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in section 4.7.3. Second, our results are not sensitive to the inclusion or exclusion of any particular country.

$$
\begin{aligned}
NI_{it} = {} & \beta_1\, NEG_{it} + \beta_2 RET_{it} + \beta_3 NEG_{it} \times RET_{it} + \beta_4 NEG_{it} \times TREAT_c \\
& + \beta_5 RET_{it} \times TREAT_c + \beta_6 NEG_{it} \times RET_{it} \times TREAT_c \\
& + \beta_7 TREAT_c \times POST_{ct} + \beta_8 NEG_{it} \times TREAT_c \times POST_{ct} \\
& + \beta_9 RET_{it} \times TREAT_c \times POST_{ct} + \beta_{10} NEG_{it} \times RET_{it} \times TREAT_c \\
& \times POST_{ct} + \lambda_i + \delta_t + \gamma'_1 \chi_{it-1} + \gamma'_2 NEG_{it} \times \chi_{it-1} + \gamma'_3 RET_{it} \\
& \times \chi_{it-1} + \gamma'_4 NEG_{it} \times RET_{it} \times \chi_{it-1} + \epsilon_{it}, \qquad (1)
\end{aligned}
$$

where i indexes firms, c indexes countries, and t indexes years. NI_{it} stands for net income before extraordinary items scaled by beginning-of-the-year market value of equity for firm i in fiscal year t. RET_{it} is the buy-and-hold stock returns over the fiscal year and is intended to reflect economic gains or losses. NEG_{it} is a binary indicator equal to one if RET_{it} is negative, and zero otherwise. $TREAT_c$ is a treatment indicator equal to one if country c passed an M&A law during the sample period, while the $POST_{ct}$ indicator equals one if country c has passed M&A laws by year t, and zero otherwise. Year fixed effects δ_t absorb time-varying factors common to all firms, such as macroeconomic fluctuations. Firm-fixed effects λ_i eliminate cross-firm differences in the expected components of earnings and returns that could bias the conservatism estimates (Ball, Kothari, and Nikolaev [2013b]). Following prior conservatism literature (Basu [2001], LaFond and Watts [2008]), the vector of firm-level controls χ_{it-1} include the natural log of firm assets (*SIZE*), market-to-book ratio (*MTB*), and leverage (*LEV*). We also include stock return volatility (*RETVOL*) because it has been shown to be an important correlated omitted variable in the Basu model (Ball, Kothari, and Nikolaev [2013b]). To ease interpretation of the interaction terms, we demean firm-level controls. In estimating equation (1), the variable *TREAT* becomes redundant due to the inclusion of firm fixed effects. *POST*, *NEG* × *POST*, *RET* × *POST*, and *NEG* × *RET* × *POST* are also omitted from the regression due to collinearity with *TREAT* × *POST*, *NEG* × *TREAT* × *POST*, *RET* × *TREAT* × *POST*, and *NEG* × *RET* × *TREAT* × *POST*, respectively.[7] To account for the fact that variations in M&A laws happen at the country level, we cluster the standard errors at the country level (Bertrand, Duflo, and Mullainathan [2004]).[8]

The key coefficient of interest is the DiD estimator β_{10}, which measures the change in the asymmetric timeliness of loss recognition for firms in countries that passed M&A law relative to firms in countries that never passed such a law. Under H1, we expect β_{10} to be positive. Armstrong,

[7] Because *POST* equals one only for treated countries in the post-law period, *POST* is equivalent to *POST*× *TREAT* and becomes redundant. For the same reason, *NEG* × *POST*, *RET* × *POST*, and *NEG* × *RET* × *POST* are redundant to *NEG* × *TREAT* × *POST*, *RET* × *TREAT* × *POST*, and *NEG* × *RET* × *TREAT* × *POST*.

[8] The point estimates (untabulated) are robust to clustering standard errors at the firm level and to two-way clustering at the country and year level.

TABLE 2
Descriptive Statistics

Variable	*N*	Mean	Median	SD	25th Percentile	75th Percentile
Panel A: Enacting countries						
POST	20,903	0.719	1.000	0.450	0.000	1.000
NI	20,903	−0.034	0.053	0.539	−0.011	0.112
NEG	20,903	0.476	0.000	0.499	0.000	1.000
RET	20,903	0.166	0.024	0.724	−0.256	0.379
SIZE	20,903	4.971	4.819	1.727	3.772	5.996
MTB	20,903	4.029	1.213	25.330	0.672	2.219
LEV	20,903	0.251	0.233	0.202	0.073	0.386
RETVOL	20,903	0.059	0.034	0.115	0.023	0.053
Panel B: Nonenacting countries						
NI	50,701	0.013	0.034	0.293	0.002	0.080
NEG	50,701	0.509	1.000	0.500	0.000	1.000
RET	50,701	0.119	−0.007	0.628	−0.236	0.296
SIZE	50,701	5.894	5.744	1.633	4.803	6.845
MTB	50,701	7.105	1.249	39.706	0.669	2.225
LEV	50,701	0.274	0.258	0.195	0.113	0.405
RETVOL	50,701	0.049	0.029	0.113	0.022	0.041

This table presents descriptive statistics for the variables in our baseline regressions. There are 20,903 firm-year observations in countries that enacted M&A law during the sample period. There are 50,701 firm-year observations in countries that did not enact M&A law during the sample period. The firm-year observations are drawn from 34 countries between 1992 and 2005 from Compustat Global. Appendix B provides variable definitions.

Guay, and Weber [2010] argue that the overall, rather than the incremental, timeliness of bad news recognition can be a more relevant measure of conservatism, so we also estimate changes in the overall timeliness of loss recognition following M&A law passage by testing whether sum $\beta_9 + \beta_{10}$ is positive.

4. Results

4.1 DESCRIPTIVE STATISTICS

Panels A and B of table 2 present descriptive statistics for variables employed in model 1 for enacting countries and nonenacting countries, respectively. In panel A, the mean value of *POST* is 0.719, indicating that 71.9% of firm-year observations in the sample of enacting countries are associated with postenactment periods.[9] The mean (median) of *NI* is –0.034

[9] To alleviate the concern that our results may be driven by a change in the sample composition between pre- and postenactment periods, we repeat our analyses for a constant sample of firms. We require firms in M&A law countries to stay in the sample for both the four years before and four years after M&A law enactment. For non-M&A law countries, we require firms to stay in the sample for both the four years before and four years after a pseudo-M&A law enactment year, which is the median enactment year across enacting countries (1998). Regression results using this smaller sample are shown in table A1 in the online appendix, and they yield inferences similar to those reported in the paper.

(0.053), suggesting that the profitability scaled by market capitalization is left skewed. About 47.6% of firm years in enacting countries experience negative returns, as reflected by the mean value of *NEG* at 0.476. The mean and median returns (*RET*) in this subsample are 0.166 and 0.024, respectively. In panel B, the mean (median) of *NI* is 0.013 (0.034), and about 50.9% of firm years are associated with negative returns, a slightly higher percentage than that for enacting firm years.

4.2 THE EFFECT OF MARKET FOR CORPORATE CONTROL ON ACCOUNTING CONSERVATISM

4.2.1. DiD Framework. Table 3 presents the DiD estimates using model 1. In column 1, we start with a specification that excludes firm-specific controls. The coefficient on $NEG \times RET \times TREAT$ is insignificant, indicating that firms in enacting countries do not differ in asymmetric timeliness of loss recognition compared with firms in nonenacting countries in the preenactment period. The coefficient on $NEG \times RET \times TREAT \times POST$ is positive (0.146) and significant at the 1% level, suggesting that following M&A law enactment, treated firms increase their asymmetric timeliness of loss recognition relative to that of control firms.

Column 2 reports the results of estimating model 1 with firm-level controls. Consistent with findings in prior research, we find larger firms and more leveraged firms report more conservatively. The point estimate for $NEG \times RET \times TREAT \times POST$ shows that M&A law adoption has a positive (coefficient = 0.149) and statistically significant ($p < 0.01$) impact on firms' asymmetric timeliness of loss recognition. The positive and significant combined coefficient of $RET \times TREAT \times POST + NEG \times RET \times TREAT \times POST$ implies a significant increase in overall (and not just asymmetric) timeliness of loss recognition following M&A law passage for treated firms versus that for control firms. Moreover, the estimated coefficient on the sum $NEG \times RET + NEG \times RET \times TREAT + NEG \times RET \times TREAT \times POST$ is 0.121 and significant at the 10% level, indicating that treated firms recognize economic losses faster than gains in the postenactment period.[10] Taken together, results in table 3 support H1, that M&A law enactments increase the extent of accounting conservatism realized in firms' financial reports.

To put the results from table 3 into perspective, it is useful to benchmark the estimates to the average level of accounting conservatism exhibited by U.S. firms over the same time period. In table A2 in the online appendix, we estimate the firm-fixed-effects Basu model for the universe of publicly listed U.S. firms from 1992 through 2005, and find the average asymmetric timeliness of loss recognition (coefficient on $NEG \times RET$) among U.S.

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[10] The estimated timely loss recognition for treatment firms after M&A law enactment ($RET + NEG \times RET + RET \times TREAT + NEG \times RET \times TREAT + RET \times TREAT \times POST + NEG \times RET \times TREAT \times POST$) is 0.211, which is 2.34 times the estimated timely gain recognition of 0.090 for treated firms after M&A law enactment ($RET + RET \times TREAT + RET \times TREAT \times POST$).

TABLE 3
The Effect of M&A Laws on Accounting Conservatism: DiD Framework

	Dependent Variable = *NI*			
	(1)		(2)	
	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β_1)	−0.010	(0.126)	−0.008	(0.147)
RET (β_2)	0.069***	(0.000)	0.065***	(0.000)
NEG × *RET* (β_3)	0.027	(0.275)	0.028	(0.180)
NEG × *TREAT* (β_4)	−0.011	(0.441)	−0.014	(0.252)
RET × *TREAT* (β_5)	−0.053**	(0.010)	−0.052***	(0.005)
NEG × *RET* × *TREAT* (β_6)	−0.041	(0.477)	−0.056	(0.395)
TREAT × *POST* (β_7)	−0.098***	(0.001)	−0.070***	(0.004)
NEG × *TREAT* × *POST* (β_8)	0.042	(0.123)	0.034	(0.183)
RET × *TREAT* × *POST* (β_9)	0.085**	(0.025)	0.077**	(0.028)
NEG × *RET* × *TREAT* × *POST* (β_{10})	0.146***	(0.007)	0.149***	(0.001)
SIZE (β_{11})			−0.045***	(0.001)
MTB (β_{12})			0.000	(0.271)
LEV (β_{13})			−0.266***	(0.001)
RETVOL (β_{14})			−0.034	(0.467)
NEG × *SIZE* (β_{15})			−0.002	(0.578)
NEG × *MTB* (β_{16})			0.000*	(0.074)
NEG × *LEV* (β_{17})			0.043	(0.294)
NEG × *RETVOL* (β_{18})			−0.028	(0.583)
RET × *SIZE* (β_{19})			−0.005	(0.190)
RET × *MTB* (β_{20})			−0.000***	(0.000)
RET × *LEV* (β_{21})			0.083*	(0.068)
RET × *RETVOL* (β_{22})			0.028	(0.449)
NEG × *RET* × *SIZE* (β_{23})			0.019**	(0.014)
NEG × *RET* × *MTB* (β_{24})			−0.000	(0.927)
NEG × *RET* × *LEV* (β_{25})			0.244***	(0.005)
NEG × *RET* × *RETVOL* (β_{26})			−0.110	(0.266)
F-test: $\beta_9+\beta_{10}$	0.231***	(0.005)	0.226***	0.001
F-test: $\beta_3+\beta_6+\beta_{10}$	0.132*	(0.062)	0.121*	(0.071)
Fixed effects	Firm, year		Firm, year	
Observations	71,604		71,604	
Adjusted-R^2	0.298		0.307	

This table presents the results of estimating the effect of M&A laws on accounting conservatism using the baseline difference-in-differences (DiD) specification 1. *TREAT* is an indicator variable equal to one for countries that enacted M&A law during the sample period, and zero for countries that never enacted M&A law. *POST* equals one in the year of the country's M&A law enactment and thereafter, and zero otherwise. The dependent variable is *NI*, defined as net income before extraordinary items scaled by beginning-of-period market value of equity. *RET* is buy-and-hold return over the fiscal year. *NEG* is an indicator variable equal to one if *RET* is negative, and zero otherwise. The (demeaned) firm-level controls are defined in appendix B. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

firms to be 0.139. Viewed in this context, the estimated asymmetric timeliness of loss recognition for treated firms in the postenactment period is 0.121, which represents 87% of the asymmetric timeliness of loss recognition of an average U.S. firm. By comparison, the estimated coefficient on the sum *NEG* × *RET* + *NEG* × *RET* × *TREAT* is –0.028 and statistically

insignificant ($p = 0.669$), which suggests that treated firms do not exhibit asymmetric timeliness of loss recognition in the pre-enactment period. The marked increase in conservatism induced by M&A laws implies that (1) absent an active market for corporate control, firms in enacting countries prefer to not accelerate incorporation of economic losses relative to gains in financial reports, which possibly is assisted by institutional infrastructure and legal environment in the country, and (2) M&A laws, by stimulating takeover market, push firms toward a substantially higher level of financial reporting conservatism (lower verification threshold for asymmetrically recognizing economic losses) close to that in the United States.

4.2.2. Event-Study Framework. Our DiD identification strategy has one limitation: it is difficult to decisively assign a control country that did not experience the shock but that shares comparable legal regime, political environment, and economic development as the affected country. We use two methods to overcome this issue. First is to restrict research to countries that passed M&A laws and trace conservatism's evolution over a narrow time window around the enactment of each M&A law. This approach is similar in spirit to an event-study framework and sidesteps the issue of heterogeneous traits between treatment and control countries that might bias the estimated effect (Fernandes and Ferreira [2009]). The event-study design will also serve as the baseline regression for the subsequent cross-sectional analysis, many of which could only be conducted within enacting countries. Our second method to be discussed in subsection 4.7.1 employs two alternative matched sample designs to mitigate the concerns that differences between our treatment and control samples could contaminate estimation.

The event-study design is confined to firms from M&A law countries and covers a symmetric event window running from four years before to four years after M&A law enactment year, excluding the enactment year.[11] We further require firms to have at least one observation in each of the pre- and postenactment periods. The regression is specified as follows:

$$\begin{aligned} NI_{it} = {} & \beta_1 NEG_{it} + \beta_2 RET_{it} + \beta_3 NEG_{it} \times RET_{it} \\ & + \beta_4 POST_{ct} + \beta_5 NEG_{it} \times POST_{ct} + \beta_6 RET_{it} \times POST_{ct} \\ & + \beta_7 NEG_{it} \times RET_{it} \times POST_{ct} + \lambda_i + \delta_t + \gamma'_1 \chi_{it-1} + \gamma'_2 NEG_{it} \\ & \times \chi_{it-1} + \gamma'_3 RET_{it} \times \chi_{it-1} + \gamma'_4 NEG_{it} \times RET_{it} \\ & \times \chi_{it-1} + \epsilon_{it}, \end{aligned} \tag{2}$$

where *POST* equals one for the four years after and zero for the four years before the takeover law enactment. All the other variables are as defined

[11] Our results are robust to using alternative event windows of three years (or five years) before and after the enactment year. Results are essentially the same when we exclude year 2005 from the event study analysis to account for the fact that German firms adopted IFRS in 2005.

TABLE 4

The Effect of M&A Laws on Accounting Conservatism: Event Framework

	Dependent Variable = *NI*			
	(1)		(2)	
	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β_1)	−0.037	(0.154)	−0.038*	(0.099)
RET (β_2)	0.004	(0.905)	0.011	(0.735)
NEG × *RET* (β_3)	−0.020	(0.777)	−0.027	(0.715)
POST (β_4)	−0.014	(0.858)	−0.016	(0.834)
NEG × *POST* (β_5)	0.040	(0.480)	0.035	(0.438)
RET × *POST* (β_6)	0.073	(0.356)	0.058	(0.445)
NEG × *RET* × *POST* (β_7)	0.285**	(0.038)	0.239**	(0.020)
SIZE (β_8)			−0.054	(0.143)
MTB (β_9)			0.002*	(0.091)
LEV (β_{10})			−0.361**	(0.014)
RETVOL (β_{11})			0.065	(0.681)
NEG × *SIZE* (β_{12})			−0.005	(0.471)
NEG × *MTB* (β_{13})			0.002	(0.389)
NEG × *LEV* (β_{14})			0.062	(0.712)
NEG × *RETVOL* (β_{15})			0.108	(0.576)
RET × *SIZE* (β_{16})			−0.012	(0.419)
RET × *MTB* (β_{17})			−0.000	(0.759)
RET × *LEV* (β_{18})			0.133	(0.149)
RET × *RETVOL* (β_{19})			−0.131	(0.386)
NEG × *RET* × *SIZE* (β_{20})			0.022	(0.235)
NEG × *RET* × *MTB* (β_{21})			−0.006	(0.422)
NEG × *RET* × *LEV* (β_{22})			0.162	(0.622)
NEG × *RET* × *RETVOL* (β_{23})			0.505***	(0.001)
F-test: $\beta_6 + \beta_7$	0.358**	(0.021)	0.297***	(0.003)
F-test: $\beta_3 + \beta_7$	0.265***	(0.009)	0.212***	(0.001)
Fixed effects	Firm, year		Firm, year	
Observations	7,680		7,680	
Adjusted-R^2	0.262		0.273	

This table presents the effect of M&A laws on accounting conservatism using the event-study specification 2. Only countries that enacted M&A law during the sample period are included. The event window spans from four years before to four years after M&A law enactment, excluding enactment year. *POST* equals one in the year of the country's M&A law enactment and thereafter, and zero otherwise. The dependent variable is *NI*, defined as net income before extraordinary items scaled by beginning-of-period market value of equity. *RET* is buy-and-hold return over the fiscal year. *NEG* is an indicator variable equal to one if *RET* is negative, and zero otherwise. The (demeaned) firm-level controls are defined in appendix B. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

in model 1. The coefficient of interest is β_7, which captures the change in asymmetric timeliness of loss recognition around M&A law enactment for treated firms.

Table 4 presents the results. As before, columns 1 and 2 report regression results without and with the set of firm-level control variables, respectively. Results suggest that firms increase asymmetric timeliness of loss recognition from the four years before to the four year after the enactment of M&A laws, reflected in the positive and significant coefficient on *NEG* × *RET*

$\times$ *POST*. The positive and significant coefficient on *RET* $\times$ *POST* + *NEG* $\times$ *RET* $\times$ *POST* corroborates that firms experience an increase in overall (and not just asymmetric) timeliness of loss recognition following the M&A law enactment. The sum *NEG* $\times$ *RET* + *NEG* $\times$ *RET* $\times$ *POST* is also positive and significant across both specifications, which indicates, in the postenactment period, treated firms' financial reports incorporate economic losses faster than gains into realized earnings. Collectively, the event-study framework confirms the DiD estimation results, assuaging concerns that our inferences are biased by unaccounted heterogeneity between enacting countries and nonenacting countries.

4.3 ECONOMIC CHANNELS

In this section, we seek to shed light on the two underlying channels through which the impact on conservatism can be realized, that is, *the real effects channel* and *the board monitoring channel*. We perform a series of analyses to explore whether the empirical results are consistent with the theoretical predictions associated with each channel.

4.3.1. Real Effects Channel. We posit that increased takeover vulnerability leads firms to use more financial leverage and reduce capital spending to credibly commit to shareholder wealth, and through these real effects, firms adopt more conservative accounting policies. We begin by estimating the effect of M&A law passage on financial leverage ratio and capital expenditures using the following DiD specification:

$$REALDECISION_{it} = \beta_1\ TREAT_c \times POST_{ct} + \lambda_i + \delta_t + \gamma' \mathrm{X}_{it-1} + \epsilon_{it}, \quad (3)$$

where $REALDECISION_{it}$ is either total debt scaled by total assets or capital expenditures scaled by beginning-of-period property, plant, and equipment for firm i in year t. The vector of firm-level control variables, X_{it-1}, include variables typically found in prior empirical research using leverage and investment as dependent variables in a regression framework (e.g., Mackay and Phillips [2005], Asker, Farre-Mensa, Ljungqvist [2015], Serfling [2016]). These variables include log assets (*SIZE*) to proxy for firm size, the market-to-book ratio (*MTB*) to control for growth opportunities, a dummy variable indicating earning losses (*LOSS*), and total cash divided by assets (*CASH*) to reflect financial slack. We also include the modified Altman's *ZSCORE* to capture financial distress, and net property, plant, and equipment as a fraction of total assets (*PPENT*) to proxy for asset tangibility. To control for variability in operating performance, we include both the standard deviations of operating cash flow (*STDCFO*) and sales revenue (*STDSALE*) over the past five years. In regression using capital expenditures as the dependent variable, we also include financial leverage (*LEV*) as a control variable. λ_i and δ_t are firm and year fixed effects, respectively. The variable *TREAT* is absorbed by firm fixed effects, and *POST* is redundant due to collinearity with *TREAT* $\times$ *POST*. The key coefficient of interest is β_1, which measures the differential change in the outcome for treated

firms relative to control firms following the enactment of M&A laws. As before, we supplement the DiD specification with the event specification in which the variable of interest is simply *POST*. Statistical inferences are drawn based on standard errors clustered at the country level.

Panel A of table 5 reports results from estimating the effect of M&A law adoption on financial leverage. The coefficient on *TREAT* × *POST* (*POST*) is positive and significant in the DiD (event) framework, suggesting that M&A law enactment leads firms to increase financial leverage. The estimated coefficient of 0.033 in column 1 implies a 3.3-percentange-point increase in book leverage ratio of treated firms relative to that of control firms following M&A law enactment. Given the average leverage ratio for treated firms in the pre-enactment period is 0.232, this effect is equivalent to a 14% increase in leverage.

Panel B of table 5 estimates the effect on capital investment. We find that M&A law adoption has a negative and statistically significant impact on capital expenditures. The point estimate in column 1 implies that passing M&A law in the country is associated with a 9.3-percentage-point decrease in the ratio of capital expenditures to property, plant, and equipment, which represents a 27% reduction in the pre-law average capital investment for treated firms (0.348).[12] The magnitude of this decline is in line with the findings in prior research. For example, using a sample of U.S. firms that successfully terminate takeover offers, Safieddine and Titman [1999] estimate that capital expenditures decrease by more than 35% for leverage-increasing target firms.

Of course, reductions in capital spending alone need not imply that management is scrapping inefficient investment projects, but rather they can be symptomatic of managers myopically cutting expenditures on value-increasing projects that generate short-term losses to reduce takeover pressure (Stein [1988]). To test for investment-efficiency implications of a takeover threat, we estimate the investment prediction model of McNichols and Stubben [2008] by industry-year using the entire universe of Compustat Global firms, and compute the deviation (in absolute value) of a firm's capital expenditures from the amount predicted.[13] A smaller (larger) gap

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[12] To examine whether some countries are driving the capital-investment results, table A3 in the online appendix compares the mean and median values of capital investment in the pre- and post-law periods for each enacting country. We find that Indonesia, Malaysia, the Philippines, and Germany have larger decreases in capital investment after takeover laws compared to other countries. Several developed countries such as Austria, Ireland, and New Zealand have smaller changes in capital investment.

[13] We estimate the model used in McNichols and Stubben [2008] by industry-year, the residual of which captures the deviation of the actual investment from that which can be predicted from the firm's investment opportunity set: $INVEST_{it} = \alpha + \beta_1 Q_{j,t-1} + \beta_2 Q\text{-}QRT2_{i,t-1} + \beta_3 Q\text{-}QRT3_{i,t-1} + \beta_4 Q\text{-}QRT4_{i,t-1} + \beta_5 CF_{it} + \beta_6 GROWTH_{i,t-1} + \beta_7 INVEST_{i,t-1} + \epsilon_{it}$, where, $INVEST_{it}$ is capital expenditures in year t scaled by the beginning-of-year property, plant, and equipment. $Q_{j,t-1}$ is Tobin's Q measured as the beginning of year t market value of assets divided by book value of assets. The market value of assets is calculated as the book value of assets

TABLE 5

Real Effects of M&A Laws and Their Impact on Conservatism

Panel A: Leverage

	(1) DID Framework		(2) Event Framework	
	Coefficient	*p*-Value	Coefficient	*p*-Value
TREAT × *POST*	0.033***	(0.000)		
POST			0.029**	(0.023)
SIZE	0.032***	(0.000)	0.001	(0.915)
MTB	−0.000	(0.757)	0.001	(0.163)
LOSS	0.008*	(0.062)	0.013**	(0.041)
CASH	−0.096***	(0.001)	−0.129***	(0.001)
ZSCORE	−0.084***	(0.000)	−0.078**	(0.014)
PPENT	0.103***	(0.000)	0.123***	(0.005)
STDCF	−0.011	(0.448)	−0.002	(0.911)
STDSALE	−0.009	(0.154)	−0.016	(0.205)
Fixed effects	Firm, year		Firm, year	
Observations	47,322		6,352	
Adjusted-R^2	0.840		0.804	

Panel B: Capital investment

	(1) DiD Framework		(2) Event Framework	
	Coefficient	*p*-Value	Coefficient	*p*-Value
TREAT × *POST*	−0.093***	(0.000)		
POST			−0.125***	(0.002)
SIZE	−0.064***	(0.000)	−0.090***	(0.007)
MTB	0.000	(0.162)	0.006	(0.255)
LEV	−0.334***	(0.000)	−0.396***	(0.001)

(*Continued*)

TABLE 5—*Continued*

Panel B: Capital investment

	(1) DID Framework		(2) Event Framework	
	Coefficient	*p*-Value	Coefficient	*p*-Value
LOSS	−0.031**	(0.010)	−0.032**	(0.034)
CASH	−0.065*	(0.095)	−0.003	(0.944)
ZSCORE	−0.001	(0.917)	0.001	(0.930)
PPENT	0.184***	(0.000)	0.172	(0.210)
STDCF	−0.005	(0.877)	−0.025	(0.676)
STDSALE	0.043*	(0.080)	0.058	(0.107)
Fixed effects	Firm, year		Firm, year	
Observations	40,885		5,766	
Adjusted-R^2	0.417		0.361	

Panel C: Linkage between the real effects of M&A laws and conservatism

	Changes in Leverage				Changes in Investment			
	(1) *HIGH_ΔLEV*		(2) *LOW_ΔLEV*		(3) *HIGH_ΔINVEST*		(4) *LOW_ΔINVEST*	
	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β1)	−0.041	(0.172)	−0.033*	(0.077)	0.014	(0.719)	−0.055*	(0.088)
RET (β_2)	0.016	(0.397)	−0.002	(0.966)	0.040	(0.115)	−0.009	(0.833)
NEG × *RET* (β_3)	−0.095	(0.235)	0.056	(0.411)	0.037	(0.721)	−0.049	(0.331)
POST (β_4)	−0.048	(0.616)	0.025	(0.524)	0.007	(0.852)	−0.054	(0.629)
NEG × *POST* (β_5)	0.051	(0.404)	0.028	(0.353)	0.004	(0.902)	0.049	(0.519)
RET × *POST* (β_6)	0.012	(0.842)	0.105*	(0.066)	0.095**	(0.049)	0.051	(0.618)

(*Continued*)

TABLE 5—*Continued*

Panel C: Linkage between the real effects of M&A laws and conservatism

	Changes in Leverage				Changes in Investment			
	(1) *HIGH_ΔLEV*		(2) *LOW_ΔLEV*		(3) *HIGH_ΔINVEST*		(4) *LOW_ΔINVEST*	
	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG × *RET* × *POST* (β_7)	0.409***	(0.000)	0.070	(0.396)	0.118	(0.110)	0.327***	(0.001)
F-test: β_7 across subsamples (*p*-value)	0.339***(0.002)				0.209***(0.009)			
Control variables	Yes		Yes		Yes		Yes	
Fixed effects	Firm, year		Firm, year		Firm, year		Firm, year	
Observations	3,865		3,815		3,443		3,514	
Adjusted-R^2	0.269		0.271		0.348		0.261	

This table presents the results of estimating the real effects of M&A laws and their interactions with changes in conservatism. Panel A estimates the effect of M&A laws on financial leverage, where the dependent variable, *LEV*, is total debt scaled by total assets. Panel B estimates the effect of M&A laws on capital investment, where the dependent variable, *INVEST*, is capital expenditures divided by beginning-of-period property, plant, and equipment. Panel C estimates the effect of M&A laws on conservatism separately for firms with above and below median changes in financial leverage (*HIGH_ΔLEV* vs. *LOW_ΔLEV*) and capital investment (*HIGH_ΔINVEST* versus *LOW_ΔINVEST*). All other variables are defined in appendix B. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

between the actual investment level and the projected investment level is indicative of more (less) efficient investment decisions. We repeat model 3 with the investment efficiency measure as the dependent variable. Results, as shown in table A4 in the online appendix, suggest a negative and significant effect of M&A law enactments on deviations of investment from fundamentals, verifying that an invigorated market for corporate control drives management to shed unproductive projects and invest closer to first-best level.

If shocks to takeover susceptibility affect conservatism through changes in real financing and investment activities, the effect should be stronger for firms that borrow more or cut capital spending more after the passage of M&A law. We now directly test for this idea. We compute firm-level changes in leverage ratio (capital investment) around M&A law as the average leverage ratio (capital investment) over the four years after the law event, less the average leverage ratio (capital investment) over the four years before the law event, divided by the average leverage ratio (capital investment) over the four years before the law event. We then split treated firms into high (above-median) and low (equal or below-median) groups, and reestimate model 2 for both subsets. The median firm-level change in leverage ratio is 0.017, and the median firm-level change in capital expenditures is –0.072. Close to 60% of firms with above-median changes in leverage also have below-median changes in capital spending, which means there is partial overlap across the two partitioning schemes.[14] We use the event-study framework for this analysis because (1) unaffected countries, by design, do not have a (pseudo) enactment year, and thus changes in real corporate decisions cannot be computed for firms in these countries, (2) confining to enacting countries removes the concern that unaccounted heterogeneity between enacting and nonenacting countries differentially impacts the interactions between changes in corporate decisions and changes in conservatism across the two sets of countries, and (3) extending beyond the four-year window might create noise around identifying the direct link between real corporate decisions and accounting conservatism.

Table 5, panel C, reports the cross-sectional results. Because not all firms have exactly eight firm-year observations in the event framework (i.e., we have an unbalanced panel) and the cutoff is set at the firm-level, there is a slight difference in the number of observations between the high- and low-change subsamples. We find that adopting M&A law leads to a

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less the book value of equity plus the market value of equity. CF_{it} is operating cash flow at the end of year t divided by beginning-of-the-year property, plant, and equipment. $GROWTH_{i,t-1}$ is the natural log of total assets at the end of year $t-1$ divided by total assets at the end of year $t-2$. $Q\text{-}QRT2_{i,t-1}$ ($Q\text{-}QRT3_{i,t-1}$, $Q\text{-}QRT4_{i,t-1}$) equals $Q_{i,t-1}$ times an indicator variable that equals one if $Q_{i,t-1}$ is in the second (third, fourth) quartile of its industry-year distribution.

[14] In table A5 in the online appendix, we report information about the extent of overlap in the partitions used in our cross-sectional analyses, which shows partial overlap across partitions.

greater increase in conservatism for firms experiencing a larger increase in leverage ratio and a greater decline in capital investment. Specifically, the coefficient on $NEG \times RET \times POST$ is positive and significant for firms with above-median changes in leverage ratio around the M&A law event, but is insignificant for firms with below-median changes in leverage. The point estimates between the two subsamples are significantly different at the 1% level according to the *F*-test. Turning to capital investment, we obtain a positive and significant coefficient on $NEG \times RET \times POST$ for firms with below-median changes in capital expenditures, while the same coefficient is marginally insignificant for firms with above-median changes in capital expenditures. The *F*-test shows that the estimated coefficients for the two subsamples are statistically different at the 1% level. The combined evidence on real activities' changes, coupled with the positive relation between these changes and firms' decisions to report more conservatively, supports our hypothesis that the impact of M&A laws on conservatism operates, at least in part, through the real effects channel.[15]

4.3.2. Board Monitoring Channel. In this section, we examine whether the effect of M&A law adoption on accounting conservatism runs through the board monitoring channel. One important board function is to provide managers with appropriate incentives through well-structured compensation contracts. We analyze whether changes in conservatism around M&A law passage vary with the extent of post-law improvement in executive pay-performance sensitivity. The use of executive pay-performance sensitivity as a proxy for boards' monitoring effectiveness is motivated by the idea that permissive boards are more likely to show allegiance to entrenched management and insulate executive compensation from the effects of poor performance (Jensen and Murphy [1990], Coles, Daniel, and Naveen [2014], Correa and Lel [2016]). If improvements in board monitoring are one of the underlying channels by which an active market for corporate control leads to greater conservatism, then this effect should be stronger among countries where executive pay-performance sensitivity improves the most.

We obtain executive compensation information from the S&P Capital IQ People Intelligence database. For each country year, we measure aggregate CEO pay-performance sensitivity as the estimated coefficient on industry-adjusted firm return on assets in a regression relating the natural logarithm of total annual CEO compensation (in 2005 U.S. dollars) to industry-adjusted firm return on assets as well as firm-level controls for the year. We use the TopKeyExecFlag provided by Capital IQ to identify compensation packages for the company's CEO. If there are multiple executives

[15] Figure A1 in the online appendix depicts the distribution of firm-level change in leverage and change in capital investment for each country using box plots. There is variation in both variables not only across countries but also across firms within each country. Thus, the cross-sectional results based on real effects are best viewed as an outcome of a combination of cross-country differences, such as institutional structure and legal environment, and cross-firm differences within a country, such as firm-level governance practices.

identified as top executives in a given firm year, we keep the executive with highest compensation. Total annual CEO compensation includes salaries, bonuses, restricted stock and option awards, long-term incentive plans, and all other compensation in U.S. dollars. Following prior work in executive compensation contracts (e.g., Faleye [2007], Correa and Lel [2016]), we include as control variables in the regression log assets (a proxy for firm size), leverage ratio (a control for capital structure), market-to-book ratio (a proxy for growth opportunities), and daily stock return volatility over the year (a proxy for firm risk).

For each enacting country, we compute the percentage growth rate in pay-performance sensitivity, ΔPPS, by averaging the year-over-year changes in pay-performance sensitivity over the post-law period. We reestimate model 2 separately for countries with low (equal or below-median) and high (above-median) growth rate in pay-performance sensitivity. The sample median pay-performance-sensitivity growth is 0.123. Countries in the high growth group are Austria, India, Ireland, Pakistan, and Taiwan. Countries in the low growth group are Chile, Germany, Malaysia, New Zealand, and the Philippines.

Panel A of table 6 reports the regression estimates. While the coefficients on $NEG \times RET \times POST$ are positive and significant across both subgroups, the coefficient for the above-median group is more than three times as large as that for the below-median group, and the difference in coefficients is statistically significant at the 10% level. We interpret these findings as consistent with the hypothesis that increased conservatism following M&A law adoption is due, in part, to directors demanding more accounting conservatism to improve monitoring.

Prior studies find that firm-level governance mechanisms, including board oversight of managerial behavior, are generally unavailable or ineffective in countries with weak institutional infrastructure (Bergman and Nicolaievsky [2007], Doidge, Karolyi, and Stulz [2007], Aggarwal et al. [2009]). The enhanced market for corporate control caused by the M&A law adoption should exert a greater kick-in-the-pants effect on permissive directors, prompting them to monitor managers more diligently and, consequently, demand greater conservatism in financial statements. Thus, the board monitoring channel predicts that the main effect should be stronger in countries with weak shareholder protection, that is, countries where corporate laws and legal regimes tend to empower entrenched directors and management against shareholders.

To measure the quality of shareholder protection, we follow Durnev and Kim [2005] and Doidge, Karolyi, and Stulz [2007] and compute the product of the antidirector rights index from Djankov et al. [2008] and the rule of law index from La Porta et al. [1998] divided by 10.[16] The measure,

[16] The antidirector rights index, originally defined in La Porta et al. [1998] and later revised in Djankov et al. [2008], captures the strength of shareholder rights in the corporate

TABLE 6
Board Monitoring Channel

Panel A: Improvement in pay-performance sensitivity

	(1) *HIGH_ΔPPS*		(2) *LOW_ΔPPS*	
	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β_1)	−0.125***	(0.000)	−0.028***	(0.001)
RET (β_2)	0.030	(0.506)	−0.019	(0.424)
NEG × *RET* (β_3)	−0.307***	(0.004)	0.035	(0.295)
POST (β_4)	0.103**	(0.024)	−0.020	(0.760)
NEG × *POST* (β_5)	0.147**	(0.011)	0.006	(0.924)
RET × *POST* (β_6)	0.072*	(0.079)	0.065	(0.443)
NEG × *RET* × *POST* (β_7)	0.540***	(0.006)	0.165**	(0.017)
F-test: β_7 across subsamples (*p*-value)	0.375* (0.073)			
Control variables	Yes		Yes	
Fixed effects	Firm, year		Firm, year	
Observations	1,781		5,385	
Adjusted-R^2	0.375		0.225	

Panel B: Shareholder protection

	(1) *HIGH_SHRPROTECT*		(2) *LOW_SHRPROTECT*	
	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β1)	−0.025***	(0.004)	−0.102**	(0.019)
RET (β_2)	−0.021	(0.379)	0.045	(0.165)
NEG × *RET* (β_3)	0.053**	(0.046)	−0.324***	(0.000)
POST (β_4)	−0.033	(0.590)	0.070	(0.434)
NEG × *POST* (β_5)	−0.001	(0.982)	0.182***	(0.005)
RET × *POST* (β_6)	0.069	(0.412)	0.069	(0.296)
NEG × *RET* × *POST* (β_7)	0.116***	(0.004)	0.584***	(0.000)
F-test: β_7 across subsamples (*p*-value)	0.468*** (0.003)			
Control variables	Yes		Yes	
Fixed effects	Firm, year		Firm, year	
Observations	5,388		2,292	
Adjusted-R^2	0.221		0.342	

This table presents the results of assessing the board monitoring channel through which the effect of M&A adoption on conservatism could arise. Panel A estimates the effect of M&A laws on conservatism separately for countries with above and below median growth rate in the sensitivity of CEO pay to firm performance (*HIGH_ΔPPS* vs. *LOW_ΔPPS*). *ΔPPS* is the average year-to-year change in CEO pay-performance sensitivity for a given country in the post-law period. CEO pay-performance sensitivity at the country-year level is computed as the estimated coefficient on industry-adjusted firm return on assets in a regression relating the natural logarithm of total annual CEO compensation (in 2005 U.S. dollars) on industry-adjusted firm return on assets as well as firm-level controls for all firms in a country year. Panel B estimates the effect of M&A laws on conservatism separately for countries with above and below median shareholder protection strength (*HIGH_SHRPROTECT* vs. *LOW_SHRPROTECT*). *SHRPROTECT* is the product of the antidirector rights index from Djankov et al. [2008] and the rule of law index from La Porta et al. [1998]. The (demeaned) firm-level controls are defined in appendix B. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

SHRPROTECT, gauges jointly the presence of corporate laws pertaining to the rights of shareholders in influencing boards of directors, as well as how well the laws are implemented and enforced in the country. A higher value of *SHRPROTECT* indicates a legal regime that is less tolerant toward entrenched boards. We assign enacting countries into two groups, based on the sample median of *SHRPROTECT*, which is 25.55. Countries at or below the cutoff are Austria, India, Indonesia, Pakistan, the Philippines, and Taiwan, and countries above the cutoff are Chile, Germany, Ireland, Malaysia, and New Zealand.

Panel B of table 6 reports the results. According to the point estimates, M&A law adoption is associated with a nearly threefold increase in conservatism among countries with weaker shareholder protection (coefficient is 0.584) relative to countries with stronger shareholder protection (coefficient is 0.116), with the differential effect being significant at the 1% level. The evidence suggests that the market for corporate control serves as an alternative disciplining force on directorial oversight, particularly when existing corporate laws and legal regimes shield ineffective boards from shareholder influence.

4.4 IDENTIFICATION ANALYSIS

4.4.1. Parallel Trends Assumption. A key identifying assumption underlying the DiD estimation is that, absent M&A law, the outcome variable would have followed parallel trends for treatment and control groups (Bertrand, Duflo, and Mullainathan [2004]). We examine the parallel trends assumption for our outcome variables—accounting conservatism, financial leverage, and capital spending—by introducing treatment-specific time trends (i.e., time trend variable interacted with the treatment dummy) in our DiD specifications (models 1 and 3). When accounting conservatism is the outcome of interest, we additionally interact treatment-specific time trends with *NEG* and *RET* in model 1 to absorb any differential trends in conservatism between the treatment and control groups. Our results, reported in table 7, are robust to this exercise, making it unlikely that our inferences are biased due to preexisting differential trends between treatment and control groups.[17]

4.4.2. Confounding Events. Another identification threat is that certain concurrent developments could systemically correlate with both the

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decision-making process. The index assumes the value between zero and six, with the presence of each of six law provisions related to shareholder protection (such as rights to vote out directors and rights to call a special shareholder meeting) coded as one and summed up. The rule-of-law index from La Porta et al. [1998] measures quality of legal rights enforcement, a de facto aspect of investor protection. The index ranges from zero to 10 with lower scores for lower quality of enforcement.

[17] Because the regression models are quite saturated, the DiD coefficient estimates for M&A laws' effect on conservatism (panel A) and financial leverage (panel B) are only significant at the 10% level.

TABLE 7
Controlling for Treatment-Specific Time Trends

Panel A: Accounting conservatism

	Dependent Variable = *NI*	
	Coefficient	*p*-Value
NEG (β1)	−0.010*	(0.086)
RET (β_2)	0.064***	(0.000)
NEG × *RET* (β_3)	0.029	(0.140)
NEG × *TREAT* (β_4)	−0.031	(0.346)
RET × *TREAT* (β_5)	−0.097*	(0.062)
NEG × *RET* × *TREAT* (β_6)	−0.098	(0.517)
TREAT × *POST* (β_7)	−0.089	(0.154)
NEG × *TREAT* × *POST* (β_8)	0.017	(0.754)
RET × *TREAT* × *POST* (β_9)	0.017	(0.857)
NEG × *RET* × *TREAT* × *POST* (β_{10})	0.146*	(0.061)
SIZE (β_{11})	−0.046***	(0.000)
MTB (β_{12})	0.000	(0.303)
LEV (β_{13})	−0.272***	(0.001)
RETVOL (β_{14})	−0.030	(0.542)
NEG × *SIZE* (β_{15})	−0.002	(0.592)
NEG × *MTB* (β_{16})	0.000*	(0.084)
NEG × *LEV* (β_{17})	0.048	(0.264)
NEG × *RETVOL* (β_{18})	−0.027	(0.585)
RET × *SIZE* (β_{19})	−0.005	(0.186)
RET × *MTB* (β_{20})	−0.000***	(0.000)
RET × *LEV* (β_{21})	0.091**	(0.043)
RET × *RETVOL* (β_{22})	0.031	(0.399)
NEG × *RET* × *SIZE* (β_{23})	0.019**	(0.015)
NEG × *RET* × *MTB* (β_{24})	−0.000	(0.909)
NEG × *RET* × *LEV* (β_{25})	0.237***	(0.006)
NEG × *RET* × *RETVOL* (β_{26})	−0.105	(0.311)
Treatment-specific trend	Included	
Treatment-specific trend × *NEG*	Included	
Treatment-specific trend × *RET*	Included	
Treatment-specific trend × *NEG* × *RET*	Included	
Fixed effects	Firm, year	
Observations	71,604	
Adjusted-R^2	0.310	

Panel B: Leverage

	Dependent Variable = *LEV*	
	Coefficient	*p*-Value
TREAT × *POST*	0.019*	(0.058)
SIZE	0.032***	(0.000)
MTB	−0.000	(0.742)
LOSS	0.008*	(0.070)
CASH	−0.098***	(0.000)
ZSCORE	−0.083***	(0.000)
PPENT	0.105***	(0.000)

(*Continued*)

TABLE 7—*Continued*

Panel B: Leverage

	Dependent Variable = *LEV*	
	Coefficient	*p*-Value
STDCF	−0.010	(0.497)
STDSALE	−0.009	(0.139)
Treatment-specific trend	Included	
Fixed effects	Firm, year	
Observations	47,322	
Adjusted-R^2	0.840	

Panel C: Capital investment

	Dependent Variable = *INVEST*	
	Coefficient	*p*-Value
TREAT × *POST*	−0.111***	(0.000)
SIZE	−0.064***	(0.000)
MTB	0.000	(0.167)
LEV	−0.336***	(0.000)
LOSS	−0.031***	(0.009)
CASH	−0.068*	(0.081)
ZSCORE	−0.000	(0.956)
PPENT	0.185***	(0.000)
STDCF	−0.004	(0.919)
STDSALE	0.044*	(0.074)
Treatment-specific trend	Included	
Fixed effects	Firm, year	
Observations	40,885	
Adjusted-R^2	0.418	

This table presents the results of controlling for treatment-specific time trends, that is, the interaction of the treatment indicator variable and linear time trend variable, in the DiD specifications 1 and 3. Panel A estimates the effect of M&A laws on conservatism, controlling additionally for treatment-specific time trends interacted with *NEG*, *RET* and *NEG* × *RET*. Panels B and C estimate the effect of M&A laws on leverage and capital spending, respectively. All other variables are defined in appendix B. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

country's M&A law adoption and changes in its firms' reporting. For example, major corporate scandals may lead the country to adopt M&A law to strengthen corporate governance and, simultaneously, cause firms to exhibit greater financial-statement conservatism as a way of aligning with shareholders. It is possible that when enacting M&A law, countries also pass other legislation that could contribute to observed increases in conservatism. We perform three sets of analyses to ascertain identification.

First, we test whether the effect is more pronounced in countries where M&A law is most effective in stimulating takeover activity. If omitted confounding events are driving the result, then we should not observe differential effects across different cuts of the sample, based on the effectiveness of the *M&A law* per se. We retrieve M&A data from the Security

TABLE 8
Does the Effectiveness of M&A Laws Matter?

	(1) *HIGH_MERGERGROWTH*		(2) *LOW_MERGERGROWTH*	
	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β_1)	−0.135**	(0.012)	−0.013	(0.540)
RET (β_2)	0.180	(0.123)	0.005	(0.875)
NEG × *RET* (β_3)	−0.614***	(0.005)	0.024	(0.653)
POST (β_4)	0.294***	(0.002)	−0.052	(0.103)
NEG × *POST* (β_5)	0.190**	(0.040)	0.012	(0.699)
RET × *POST* (β_6)	−0.046	(0.729)	0.063*	(0.088)
NEG × *RET* × *POST* (β_7)	0.890***	(0.002)	0.225**	(0.022)
F-test: β_7 across subsamples (*p*-value)	0.665** (0.029)			
Control variables	Yes		Yes	
Fixed effects	Firm, year		Firm, year	
Observations	1,059		6,621	
Adjusted-R^2	0.324		0.262	

This table presents the results of estimating the effect of M&A laws on conservatism separately for countries with above and below median growth in merger activity around M&A law adoption (*HIGH_MERGERGROWTH* vs. *LOW_MERGERGROWTH*). The (demeaned) firm-level controls are defined in appendix B. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

Data Corporation (SDC) M&A database and separate treated countries into two groups, based on the median growth in takeover activity around M&A law adoption. Takeover activity growth is defined as the difference in the total number of completed M&A between four years before and four years after the enactment year, divided by the total number of completed M&A in the four years before the enactment year.[18] We report the results in table 8. We estimate a *NEG* × *RET* × *POST* interaction coefficient of 0.89 ($p < 0.01$) for countries that experienced above-median takeover-activity increase, about four times as large as the coefficient estimate of 0.225 ($p = 0.022$) for countries with below-median takeover-activity growth.

Second, we add "country × year" fixed effects to the existing set of firm and year fixed effects in the baseline DiD regressions. This approach allows us to flexibly account for *time-varying* economic or regulatory shocks in a *particular* country that can be correlated with the country's decision to pass M&A law and individual corporations' financial reporting characteristics. We report the regression estimates in table A6 in the online appendix. Even in this strict specification, we continue to find a positive and significant effect of M&A laws on conservatism, although the magnitude (0.094) and

[18] The median growth rate of mergers and acquisitions from four years before to four years after the adoption of an M&A law in the sample is 35%. Countries in the high merger growth group are Austria, India, Ireland, Pakistan, and the Philippines. Countries in the low merger growth group are Chile, Germany, Indonesia, Malaysia, New Zealand, and Taiwan. We find nearly identical results when we use growth rate of merger *intensity* defined as the total number of merger and acquisition transactions divided by the total number of firms in the country.

statistical significance ($p = 0.071$) of the point estimate is reduced compared to those in table 3, column 2.[19]

Third, we directly control for contemporaneous regulatory shocks—short selling regulations, insider trading laws, employment protection legislation, and other financial reforms—and time-varying country characteristics that could potentially affect accounting conservatism. We code an indicator $SHORTSELL_{ct}$ equal to one when short selling is legal in country c by year t, and zero otherwise, based on short-selling regulations data from Jain et al. [2013]. $INSIDER_{ct}$ equals one when insider trading laws are enforced in country c by year t, and zero otherwise. Insider trading laws enforcement data are from Bhattacharya and Daouk [2002]. We use the employment protection legislation strictness index (EPL_{ct}), reported by the Organization for Economic Co-operation and Development (OECD), to capture regulatory shifts in employment protection legislations. *EPL* is a time-varying measure ranging from 0 to 6, with greater values indicating laws more protective of employees. None of those regulations overlap completely with M&A law enactments across treated countries, which on its own, mitigates the concerns about correlated regulatory shocks. To account for other omitted concurrent regulatory shifts, we use the financial reform index $FINREFORM_{ct}$ constructed by Abiad, Detragiache, and Tressel [2010], which captures financial-policy changes along multiple dimensions such as credit controls and reserve requirements, interest rate controls, and banking regulations.

We include annual growth in gross domestic product (GDP) to account for the impact of changing economic condition on financial reporting. In light of Bushman and Piotroski's [2006] finding that judicial system and political economy shapes reporting conservatism, the regression also includes judicial impartiality as well as government enterprises and investment as a percentage of total investment, data for which come from the Economic Freedom of the World 2014 Annual Report.

We augment the baseline DiD specification with the contemporaneous country characteristics and their interactions with *NEG* and *POST*. Because employment protection legislation index (*EPL*) is available only for OECD countries during the sample period, we run the regression both with and without *EPL*. In table A8 in the online appendix, we observe that $NEG \times RET \times TREAT \times POST$ draws positive and significant coefficients, indicating that our results are not driven by concurrent legal shocks.

Fourth, we conduct a placebo test where we use nonenacting countries as the counterfactual treatment group and randomly assign (with replacement) a fictitious M&A law event to each nonenacting country. We code a counterfactual treatment indicator *FALSETREAT* that equals one

[19] The DiD coefficient estimate is significant at the 10% level largely because the regression model is quite saturated. Our cross-sectional analyses, reported in table A7 in the online appendix, are also robust to the inclusion of "country × year" fixed effects.

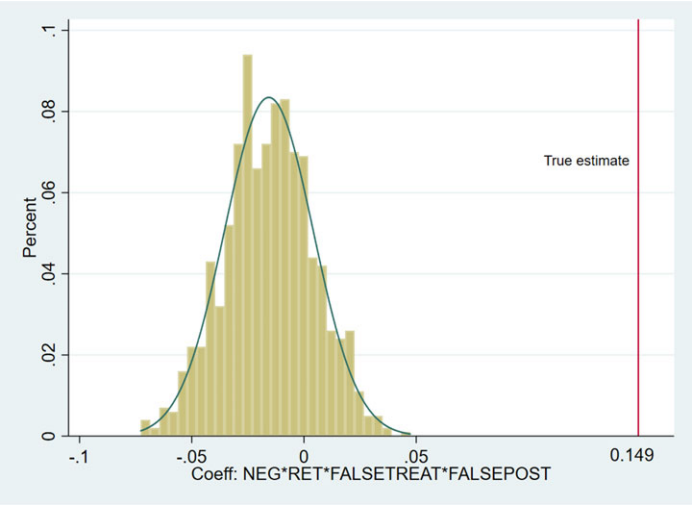

FIG. 1.——Placebo tests. This figure plots the distribution of 1,000 placebo estimates for the effect of M&A law enactments on accounting conservatism. Each placebo estimate is created by randomly assigning (with replacement) fictitious M&A law enactments to nonenacting countries and generating a difference-in-differences estimate using the fictitious law events. Specifically, we replace the true *TREAT* and *POST* in the baseline specification 1 with counterfactual *FALSETREAT* and *FALSEPOST*. *FALSETREAT* equals one for nonenacting countries, and zero for enacting countries. *FALSEPOST* is an indicator for the year of the fictitious M&A enactment and thereafter, and zero otherwise. The coefficient estimate on *NEG* × *RET* × *FALSETREAT* × *FALSEPOST* represents the placebo estimate. The vertical solid line represents the true difference-in-differences estimate, which is taken from column 2 of table 3.

for nonenacting countries, and zero for enacting countries. *FALSEPOST* is coded as one beginning from the counterfactual enactment year, and zero otherwise. We then reestimate model 1 replacing *TREAT* and *POST* with *FALSETREAT* and *FALSEPOST*, respectively. We repeat this exercise 1,000 times and plot the distribution of the placebo estimates, *NEG* × *RET* × *FALSETREAT* × *FALSEPOST*, in figure 1. For comparison, the true estimate from column 2 of table 3 is shown as a vertical line. The figure reveals that the true estimate lies well above the distribution of the estimates from the placebo test. The placebo result removes any residual concern that confounding sources other than the M&A law enactment drive the results.[20]

[20] We perform analogous placebo exercises for the effects of M&A laws on leverage and capital investment. Simulation results, reported in figure A2 in the online appendix, show true estimates are far larger (smaller) than any of the placebo estimates for leverage (capital investment).

4.5 ACCOUNTING POLICY

We explore specific accounting practices that could contribute to increased conservatism in financial statements following M&A law adoption. Following the approach of Gormley, Kim, and Martin [2012], we regress several accounting choice variables on *TREAT* × *POST*, firm-level controls, as well as the full set of firm and year fixed effects. As in model 1, firm-level controls include log assets, market-to-book ratio, leverage, and return volatility. Table 9, column 1, shows that M&A law adoption is associated with increased provisions for uncollectible accounts receivable, scaled by net receivables. This finding is consistent with firms accounting more conservatively by recognizing uncollectible debt sooner upon adverse events. Column 2 shows firms record more negative special items, such as asset write-down and impairment of intangible assets, in financial statements following the adoption of M&A law. In columns 3 and 4, we find that M&A law adoption is followed by a significant increase in accrued expenses and selling, general and administrative expenses, respectively. Both increases can contribute to the observed increase in timelier loss recognition in financial reports.

4.6 AN ALTERNATIVE EXPLANATION

In this section, we consider an alternative channel through which the conservatism effect might operate—the agency cost of debt channel. Theory suggests that while an active market for corporate control aligns the interests of managers and shareholders, it could escalate the shareholder/debtholder agency conflicts (Jensen and Meckling [1976]). This agency cost of debt issue could arise for two reasons. First, and in a broader sense, because equity claims on a levered firm resemble a call option on the firm's cash flow distribution, a pro-shareholder manager has the incentive to shift investments into high-risk projects in pursuit of higher returns for the shareholders, increasing the likelihood that the firm will become distressed or go bankrupt. Second and more specific to the takeover market, when management anticipates an unsolicited takeover bid, it will react by recapitalizing the firm through higher seniority debt issuance or selling the excess liquid assets to fend off the takeover, which can potentially hurt debtholder interests (Chava, Livdan, and Purnanandam [2009]). To the extent accounting conservatism acts as an effective contractual tool for debtholders to mitigate wealth expropriation by shareholders (Watts [2003], Nikolaev [2010]), debtholders may demand more conservative reporting in response to increased takeover threat.

We test for this explanation by examining whether loans made to firms under M&A law regimes reflect the heighted agency cost of debt. If the passage of M&A law results in wealth transfer from debtholders to shareholders, then, conditional on granting a loan, lenders will impose stricter credit terms to account for the risk of wealth expropriation. To test this

TABLE 9

Bad Debt Expenses, Special Items, Accrued Expenses, and SG&A

	(1) *BADDEBT*		(2) *SPECIALITEM*		(3) *ACCRUEDXP*		(4) *SG&A*	
	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value
TREAT × *POST*	0.038**	(0.043)	−0.349*	(0.065)	0.011**	(0.039)	0.016**	(0.023)
Control variable	Yes		Yes		Yes		Yes	
Fixed effects	Firm, year		Firm, year		Firm, year		Firm, year	
Observations	39,504		67,644		71,290		67,508	
Adjusted-R^2	0.634		0.106		0.613		0.767	

This table presents the results of examining specific accounting policies and practices through which firms increase the degree of conservatism in financial statements using a DiD specification. *TREAT* is an indicator variable equal to one for countries that enacted M&A law during the sample period, and zero for countries that never enacted M&A law. *POST* equals one in the year of the country's M&A law enactment and thereafter, and zero otherwise. *BADDEBT* is provisions for uncollectible accounts receivable divided by net receivables. *SPECIALITEM* is special item, which includes write-down of assets and impairments of intangibles, scaled by market capitalization of the firm. *ACCRUEDXP* is the accrued expenses divided by net sales. *SG&A* is selling, general and administrative expenses divided by net sales. Control variables include the natural log of firm assets, the market-to-book ratio, financial leverage ratio, and return volatility, which are demeaned in the regressions. Data on provisions for uncollectible accounts receivable and net receivables are from Thomson Reuters Worldscope database. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

conjecture, we retrieve syndicated bank loan information from Thomson Reuters DealScan database and estimate the impact of country-level M&A law adoption on interest rates and covenant intensity of bank loans issued to the firms in our sample. The regression takes the following form:

$$TERM_{jit} = \beta\,(TREAT_c \times POST_{ct}) + \lambda_i + \delta_t + \sigma' U_{jit} + \gamma' \chi_{it} - 1 + + \epsilon_{it}, \quad (4)$$

where $TERM_{jit}$ is either interest rate spread (*SPREAD*) or covenant intensity (*COVENANT*) for loan j taken by firm i in year t. The unit of observation is a newly issued loan facility. *SPREAD* is the natural log of the all-in-drawn spread (in basis points), defined as the interest margin over London Interbank Offered Rate (LIBOR) or a LIBOR equivalent for each dollar drawn down, plus annual facilities fees. *COVENANT* is the number of covenants present in the loan contract. U_{jit} and χ_{it-1} represent loan and borrower characteristics typically seen as important determinants of loan contract terms (Graham, Li, and Qiu [2008], Costello and Wittenberg-Moerman [2011]). Note that λ_i and δ_t are firm and year fixed effects.

As reported in table 10, the point estimate for *TREAT* × *POST* is insignificant for both *SPREAD* and *COVENANT*, suggesting that loans made to firms affected by M&A laws do not carry higher interest rates or more covenant requirements relative to loans made to firms unaffected by M&A laws. The lack of statistical significance for the estimated coefficient is not driven by potential multicollinearity among control variables, as the results prevail when we include only *SIZE*, *MTB*, and *LEV* in columns 1 and 3. Overall, our results suggest that agency cost of debt is unlikely to drive M&A laws' effect.[21]

4.7 SENSITIVITY TESTS

4.7.1. Alternative, Matched Samples. We test the robustness of our results using two alternative, matched sample designs to mitigate the concern that our DiD results are driven by unaccounted time-varying heterogeneity between the treatment and control samples. In the first approach, we perform a portfolio-matching scheme to construct a sample of firms subject

[21] To assess whether the lack of change in loan terms is due to increased conservatism and real effects offsetting potential agency cost of debt, we repeat the analysis for a subset of treatment firms that did not experience the predicted real effects and increases in conservatism after M&A enactments; specifically, firms with below-median change in accounting conservatism, below-median change in leverage, and above-median change in capital investment after M&A enactment. We find that for this subset of firms, loan spread increases significantly after M&A enactments, whereas covenant intensity does not change. At face value, this result implies that firms without offsetting real effects and accounting conservatism change appear to get punished in their cost of borrowing after the enactment of M&A laws. However, we interpret this finding with caution because (1) the sample size for the subsample analysis is small, (2) the effect only resides in loan spread but not in covenant, and (3) there could be relevant omitted factors for debt pricing that are not accounted for in our model. We report the subsample analysis in table A9 in the online appendix.

TABLE 10

Agency Cost of Debt Explanations

	Dependent Variable = *SPREAD*				Dependent Variable = *COVENANT*			
	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value	Coefficient	*p*-Value
TREAT × *POST*	0.081	(0.561)	0.172	(0.299)	0.042	(0.649)	−0.004	(0.955)
SIZE	−0.073	(0.276)	−0.089	(0.176)	−0.082	(0.511)	−0.058	(0.729)
MTB	0.001	(0.263)	0.000	(0.307)	0.000	(0.521)	0.000	(0.931)
LEV	0.612	(0.107)	0.542*	(0.073)	−0.018	(0.949)	0.171	(0.617)
LOSS			0.211	(0.103)			0.121	(0.521)
CASH			0.380	(0.450)			−0.552	(0.365)
ZSCORE			−0.063	(0.452)			0.125	(0.254)
PPENT			0.073	(0.824)			−0.377	(0.420)
INTCOVERAGE			−0.002	(0.424)			0.005	(0.519)
CAPEX			−0.107	(0.350)			0.062	(0.716)
MATURITY			0.118**	(0.019)			−0.022	(0.525)
LOANSIZE			−0.005	(0.890)			0.019	(0.291)
COLLATERAL			0.282**	(0.030)			0.352***	(0.003)
REVOLVER			−0.145**	(0.022)			−0.009	(0.733)
Fixed effects	Firm, year		Firm, year		Firm, year		Firm, year	
Observations	2,782		2,421		3,700		3,187	
Adjusted-R^2	0.570		0.618		0.489		0.526	

This table presents the results of estimating the effects of M&A laws on interest rate and covenant intensity of loans issued to firms subject to M&A laws versus loans issued to firms not subject to M&A laws using specification 4. *SPREAD* is the natural log of the all-in-drawn spread (in basis points), defined as the interest margin over London Interbank Offered Rate (LIBOR) or a LIBOR equivalent for each dollar drawn down plus annual facility fees. *COVENANT* is the number of covenants present in the loan contract. All other variables are defined in appendix B. Borrower firm fixed effects and loan issuance year fixed effects are included. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

TABLE 11
Alternative Matching Schemes

	Dependent Variable = *NI*			
	(1) Portfolio Firm Matching		(2) Neighbor Country Matching	
	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β_1)	−0.019	(0.161)	0.000	(0.969)
RET (β_2)	0.075***	(0.000)	0.066***	(0.000)
NEG × *RET* (β_3)	−0.012	(0.744)	0.058**	(0.021)
NEG × *TREAT* (β_4)	−0.015	(0.481)	−0.021	(0.112)
RET × *TREAT* (β_5)	−0.064**	(0.016)	−0.047**	(0.011)
NEG × *RET* × *TREAT* (β_6)	−0.049	(0.636)	−0.053	(0.480)
TREAT × *POST* (β_7)	−0.039	(0.275)	−0.065**	(0.015)
NEG × *TREAT* × *POST* (β_8)	0.036**	(0.040)	0.032	(0.233)
RET × *TREAT* × *POST* (β_9)	0.078*	(0.063)	0.061*	(0.097)
NEG × *RET* × *TREAT* × *POST* (β_{10})	0.213***	(0.000)	0.132**	(0.017)
Control variables	Yes		Yes	
Fixed effects	Firm, year		Firm, year	
Observations	17,118		63,657	
Adjusted-R^2	0.314		0.326	

This table presents the effect of M&A laws on accounting conservatism, using two alternative matching schemes. In column 1, a portfolio-matching scheme is used to construct a sample of firms subject to, and not subject to, M&A laws that share similar characteristics in the year of M&A law adoption. Each treated firm is matched with replacement to a control firm, based on country legal origin (i.e., common law vs. others), economic development (i.e., emerging markets vs. developed markets), two-digit SIC industry, total asset tercile and return on assets tercile. Any remaining ties are resolved based on the smallest difference in leverage ratio. Column 2 maps each M&A law-enacting country to an adjacent neighbor country that did not enact M&A law. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

to, and not subject to, M&A laws that share similar characteristics in the year of M&A law adoption. We map each treated firm with replacement to a control firm that is incorporated in a country with similar legal origin (i.e., common law vs. others) and comparable economic development (i.e., emerging markets vs. developed markets), and that operates in the same industry (two-digit SIC code) as the affected firm. We further require candidate control firms to be in the same total asset tercile and return on assets tercile as the treated firm. We break any remaining ties, based on the smallest difference in leverage ratio. We rerun regression (1) using the matched sample. Results reported in column 1 of table 11 show that the coefficient on *NEG* × *RET* × *TREAT* × *POST* is 0.213 and significant at the 1% level.

Second, we follow the strategy of Jayaraman [2012] and map each M&A law-enacting country to an adjacent neighbor country that did not enact M&A law. For example, Austria, which enacted M&A law in 1998, is matched with Denmark, which did not enact M&A law. Similarly, Indonesia, which enacted M&A law in 1998, is matched with Thailand. The

premise underlying this approach is that geographically proximate countries share arguably similar institutional characteristics such as regulatory environment, political climate, and economic development, which reduces the likelihood that the treatment effect is driven by heterogeneity between affected and control countries. We repeat regression (1) with firms from both treated and control countries, and report the results in column 2 of table 10. The results continue to show a positive and significant impact of M&A laws on conservatism. The collective evidence obtained from the two alternative, matched samples provides corroborating evidence that our results are not driven by the choice of control sample firms.

4.7.2. Alternative Measures of Conservatism. We check whether our results are sensitive to alternative measures of accounting conservatism. We first employ the piecewise linear accruals cash flow change model of Ball and Shivakumar [2006] to capture asymmetrically timely loss recognition. Note that this measure does not rely on stock returns to reflect the nature of economic news as in the Basu model, which helps to mitigate the concern that stock prices in less developed capital markets might not be sufficiently informative (Morck, Yeung, and Yu [2000]. We estimate the following model with standard errors clustered at the country level:

$$\begin{aligned} ACC_{it} = {} & \beta_1 D\Delta CF_{it} + \beta_2 \Delta CF_{it} + \beta_3 D\Delta CF_{it} \times \Delta CF_{it} + \beta_4 D\Delta CF_{it} \\ & \times TREAT_C + \beta_5 \Delta CF_{it} \times TREAT_c + \beta_6 D\Delta CF_{it} \\ & \times \Delta CF_{it} \times TREAT_c + \beta_7 TREAT_c \times POST_{ct} + \beta_8 D\Delta CF_{it} \\ & \times TREAT_c \times POST_{ct} + \beta_9 \Delta CF_{it} \times TREAT_c \times POST_{ct} \\ & + \beta_{10} D\Delta CF_{it} \times \Delta CF_{it} \times TREAT_c \times POST_{ct} \\ & + \lambda_i + \delta_t + \gamma_1' \chi_{it-1} + \gamma_2' D\Delta CF_{it} \times \chi_{it-1} + \gamma_3' \Delta CF_{it} \\ & \times \chi_{it-1} + \gamma_4' D\Delta CF_{it} \times \Delta CF_{it} \times \chi_{it-1} + \epsilon_{it}, \end{aligned} \tag{5}$$

where ΔCF_{it} is change in operating cash flows from year $t-1$ to t, scaled by total assets at the beginning of the year; ACC_{it} is accruals in year t, measured as earnings before extraordinary items, less cash flow from operations and scaled by beginning-of-the-period total assets; $D\Delta CF_{it}$ is a loss indicator equal to one if ΔCF_{it} is negative, and zero otherwise. Given that change in current period cash flows reflect revisions in expectations of future cash flows (Ball and Shivakumar [2006]), conservatism accounting requires a decrease in cash flows to be recognized more quickly in earnings than an increase in cash flows; that is, the coefficient on $D\Delta CF \times \Delta CF$ should be positive. Thus, an increase in conservatism following the adoption of M&A law would require the DiD estimator β_{10} on $D\Delta CF \times \Delta CF \times TREAT \times POST$ interaction to be significantly positive.

Panel A of table 12 presents the results. The coefficient on $D\Delta CF \times \Delta CF \times TREAT \times POST$ in column 2 where firm-level controls are included equals 0.154 and is significant at the 5% level. This result suggests that following

TABLE 12
Alternative Measures of Conservatism

Panel A: Piecewise linear model of accruals on change in operating cash flows

	Dependent Variable = *ACC*			
	(1)		(2)	
	Coefficient	*p*-Value	Coefficient	*p*-Value
$D\Delta CF$ (β_1)	−0.000	(0.863)	−0.002	(0.280)
ΔCF (β_2)	−0.454***	(0.000)	−0.494***	(0.000)
$D\Delta CF \times \Delta CF$ (β_3)	0.065***	(0.004)	0.109***	(0.001)
$D\Delta CF \times TREAT$ (β_4)	−0.006	(0.106)	−0.006*	(0.092)
$\Delta CF \times TREAT$ (β_5)	0.039	(0.624)	0.040	(0.619)
$D\Delta CF \times \Delta CF \times TREAT$ (β_6)	−0.187***	(0.002)	−0.194***	(0.007)
$TREAT \times POST$ (β_7)	−0.019***	(0.003)	−0.014**	(0.018)
$D\Delta CF \times TREAT \times POST$ (β_8)	0.008**	(0.012)	0.006**	(0.044)
$\Delta CF \times TREAT \times POST$ (β_9)	0.025	(0.595)	−0.023	(0.700)
$D\Delta CF \times \Delta CF \times TREAT \times POST$ (β_{10})	0.089**	(0.039)	0.154**	(0.032)
Control variable	No		Yes	
Fixed effects	Firm, year		Firm, year	
Observations	48,179		48,179	
Adjusted-R^2	0.396		0.408	

Panel B: Accrual asymmetry

	Dependent Variable = *ACC_MV*			
	(1)		(2)	
	Coefficient	*p*-Value	Coefficient	*p*-Value
NEG (β_1)	0.008	(0.550)	0.046	(0.164)
RET (β_2)	−0.016	(0.350)	0.090**	(0.013)
$NEG \times RET$ (β_3)	−0.068	(0.111)	−0.085	(0.211)
$NEG \times TREAT$ (β_4)	0.045*	(0.096)	0.029	(0.369)
$RET \times TREAT$ (β_5)	0.023	(0.418)	0.009	(0.754)
$NEG \times RET \times TREAT$ (β_6)	−0.064	(0.422)	−0.105	(0.152)
$TREAT \times POST$ (β_7)	−0.035	(0.438)	0.013	(0.767)
$NEG \times TREAT \times POST$ (β_8)	−0.047	(0.221)	−0.049	(0.156)
$RET \times TREAT \times POST$ (β_9)	−0.014	(0.608)	−0.014	(0.614)
$NEG \times RET \times TREAT \times POST$ (β_{10})	0.230**	(0.027)	0.247**	(0.011)
Control variable	No		Yes	
Fixed effects	Firm, year		Firm, year	
Observations	52,399		52,399	
Adjusted-R^2	0.273		0.291	

This table presents the results of using alternative measures of conservatism. Panel A displays the results of estimating Ball and Shivakumar's [2006] piecewise linear model of accruals on change in operating cash flows. Panel B displays the results of using accrual asymmetric timeliness following Collins, Hribar, and Tian [2014]. All variables are defined in appendix B. Firm-level controls including *SIZE*, *MTB*, *LEV*, and *RETVOL* are demeaned. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively, using two-tailed tests. *p*-values are calculated using clustered standard errors at the country level.

M&A law enactment, asymmetric timeliness of loss recognition increases more for treated firms relative to control firms.

Because accounting conservatism flows through accruals, cash flow asymmetry can add noise to Basu regression estimates. To eliminate this bias, we follow Collins, Hribar, and Tian [2014] and use only the accrual component of earnings as the dependent variable in model 1. Panel B of table 12 presents the results. The coefficient on $NEG \times RET \times TREAT \times POST$ in column 2 equals 0.247 and is significant at close to the 1% level.[22] Overall, alternative measures of accounting conservatism validate the documented effect of M&A law enactments.

4.7.3. Using a Country-Year Panel. We further test the robustness of our results by aggregating the data to the country-year level. We run a Basu [1997] model for each country and year in the first stage and save the coefficient on $RET \times NEG$ as a country-year measure of asymmetrically timely loss recognition. In the second stage, we regress this country-year measure on $TREAT \times POST$, country-year-level controls, and country and year fixed effects. Country-year-level controls are derived by averaging the corresponding firm log assets, market-to-book ratio, leverage, and return volatility across firms in the country year. Results, presented in table A10 in the online appendix, suggest, in aggregate, M&A law–enacting countries experience an increase in financial-reporting conservatism relative to nonenacting countries.

5. Conclusion

In this paper, we examine the effect of the disciplinary market for corporate control on accounting conservatism by exploiting the staggered initiation by country of M&A law, which aimed at reducing friction to M&A, as a plausibly exogenous increase in firm takeover susceptibility. Our analyses reveal a significant increase in the degree of accounting conservatism in firms' financial statements after country-level passage of an M&A law. A country's M&A law enactment is associated with a concomitant increase in financial leverage and a decrease in capital investment at the firm level, with the conservatism impact being particularly strong when firms ratchet up debt or cut capital spending more. This finding is consistent with a real effects channel, in which the elevated threat of takeover compels managers to implement changes to real corporate activities, creating significant knock-on effects on accounting conservatism.

The increase in conservatism is also greater in countries where CEO compensation becomes increasingly aligned with firm performance post–M&A

[22] We also reestimate equation (1) using operating cash flow as the dependent variable. Untabulated results indicate that the coefficient on $NEG \times RET \times TREAT \times POST$ is not statistically significant, suggesting that our results are not driven by operating cash flow asymmetry.

law, and in countries where shareholders' legal protection against ineffective boards had been weak. This finding is suggestive of a board monitoring channel, which posits that increased conservatism stems, in part, from directors demanding more conservative financial reports to aid in the implementation of more rigorous monitoring in the presence of a takeover threat. Overall, our findings speak to a causal link between increased takeover threat and accounting conservatism within the broader corporate governance landscape in an international setting. The evidence also highlights the influence of real effects on the takeover threat-accounting conservatism relation.

APPENDIX A

Provisions of M&A Laws by Country

Austria: Takeover Act

- General principles: Equal treatment and protection of shareholders of the target company; false markets used to influence stock price are prohibited; takeover must be conducted quickly and without hindrance; fair, efficient, and transparent takeover process.
- Mandatory bid is required once bidder controls 30% of the voting rights.
- Intention to control is disclosed once bidder controls 30% of voting rights.
- Bidder can squeezeout minority shareholders after controlling 90% of voting rights.
- Once the target becomes aware of the bidder's intention, the target's supervisory board and management cannot take measures to prevent the takeover without the approval of shareholders. Exceptions include the ability of the target to search for a competing bidder (i.e., white knight).

Sources: IBA; Nenova [2006]; Austrian Takeover Act.

Chile: Tender Offer Act

- General principles: Ensure shareholder protection, transparency, and equal treatment of shareholders of the target company; improve and enhance regulations governing tender offers of publicly traded firms and create a new regulatory framework for tender offers.
- Mandatory bid is required once bidder controls 50% of the voting rights.
- Intention to control is disclosed once bidder controls 15% of voting rights.
- Bidder can squeezeout minority shareholders after controlling 90% of voting rights.
- Any activity of an executive that may modify the target company's value or interests during the tender offer is prohibited.

Sources: IBA; Nenova [2006], Oyanedel [2000], Clarke de la Cerda and Barsallo [2009].

Germany: Securities Acquisition and Takeover Act

- General principles: Equal treatment of shareholders, transparency, and avoidance of market distortion.
- Mandatory bid is required once bidder controls 30% of the voting rights.
- Intention to control is disclosed once bidder controls 30% of voting rights.
- Bidder can squeezeout minority shareholders after controlling 95% of voting rights.

APPENDIX A–*Continued*

- The management board of the target company may not carry out any actions that might prevent the success of the bid, unless approved by the supervisory board or a shareholders' meeting.

Sources: German Securities Acquisition and Takeover Act; IBA; Baum [2006], Nenova [2006], Odenius [2008].

India: Substantial Acquisition of Shares and Takeovers

- General principles: Establish a clear, transparent regulatory structure for takeovers; fair and equitable treatment of shareholders.
- Mandatory bid is required once bidder controls 15% of the voting rights.
- Intention to control is disclosed once bidder controls 15% of voting rights.
- The board of the target company is restricted in its efforts to frustrate bids by disposing assets, searching for competing bids, and issuing authorized shares.

Sources: Substantial Acquisition of Shares and Takeovers; IBA; Nenova [2006], Mathew [2007].

Indonesia: Government Regulation No. 27/1998

- General principles: Promote the protection of shareholders during takeovers and facilitate an efficient bidding process.
- Mandatory bid is required once bidder controls 25% of the voting rights.
- Intention to control is disclosed once bidder controls 25% of voting rights.

Sources: IFLR; Nenova [2006], Makes [2013].

Ireland: Takeover Panel Act

- General principles: Provide an orderly framework within which takeovers are conducted; promote the equal treatment of shareholders; prohibit false markets.
- Mandatory bid is required once bidder controls 30% of the voting rights.
- Intention to control is disclosed once bidder controls 30% of voting rights.
- The board of the target company must act in the interest of the company as a whole and must not deny shareholders the opportunity to decide on the merits of the bid.
- Allows for takeover agreements, if approved by the High Court, which could reduce stamp duty taxes.

Sources: Irish Takeover Panel Act; IBA.

Malaysia: Code on Takeovers and Mergers

- General principles: Equal protection of shareholders during the bidding process.
- Mandatory bid is required once bidder controls 33% of the voting rights.
- Intention to control is disclosed once bidder controls 33% of voting rights.
- Prohibits the board from taking actions that would frustrate a bid, unless they have shareholder approval.

Sources: Malaysian Code on Takeovers and Mergers; Goo and Khan [2011].

New Zealand: Takeovers Code

- General principles: Ensure that shareholders are well informed and can participate in company changes.
- Shareholders are notified of intention of a bidder to increase control above 20%.
- Bidder can squeezeout minority shareholders after controlling 90% of voting rights.

APPENDIX A–*Continued*

- The board of the target company is prohibited from taking actions that would frustrate a bid, unless it has shareholder approval.

Sources: Takeovers Panel [2014].

Pakistan: Ordinance on Substantial Acquisition of Shares and Takeovers of Listed Companies

- General principles: Fair and equal treatment of target company shareholders throughout the takeover; transparent and efficient takeover process.
- Mandatory bid is required once bidder controls 49% of the voting rights.
- Intention to control is disclosed once bidder controls 50% of voting rights.
- During the offer period, the board of the target company cannot alter or sell assets (unless as a part of ordinary business), enter into material contracts, or issue voting shares.

Sources: Ordinance on Substantial Acquisition of Shares and Takeovers; Nenova [2006].

Philippines: Tender Offer Rules

- General principles: Fair and equal treatment of shareholders during the bidding process; provide shareholders with accurate and timely information to enable them decide whether to accept or reject the offer.
- Mandatory bid is required once bidder controls 50% of the voting rights.
- Intention to control is disclosed once bidder controls 5% of voting rights.
- Simplified procedures for obtaining government approval of M&As.

Sources: IFLR; Cabacungan [2000], Nenova [2006], Lel and Miller [2015].

Sri Lanka: Company Takeovers and Mergers Code

- General principles: Fair and equal treatment of shareholders in target companies.
- Mandatory bid is required once bidder controls 30% of the voting rights.
- Intention to control is disclosed once bidder controls 30% of voting rights.
- Restricts management of target companies from taking harmful defensive action to frustrate the takeover.

Sources: IBA; Nenova [2006].

Taiwan: Business Mergers and Acquisitions Act

- General principles: Simplify the application of various laws in connection with M&As; streamline procedures related to M&As; provide tax benefits to encourage M&As; equal treatment of shareholders during M&As.
- Mandatory bid is required once bidder controls 20% of the voting rights.
- Disclosure of holdings of 10% of outstanding shares or more.
- Introduces new types of mergers, including whale-minnow mergers, cash-out mergers, and cross-border mergers.
- Reduces transaction taxes stemming from M&As.
- Provides additional protections to employees regarding their right to determine whether or not to be transferred.

Sources: IFLR; Hanley [2008].

APPENDIX B

Variable Definitions

Variable	Definition
Variables used in baseline regressions	
TREAT	An indicator variable equal to one for countries that enacted M&A law during the sample period, and zero for countries that never enacted M&A law.
POST	An indicator variable equal to one in the year of the country's M&A law enactment and thereafter, and zero otherwise. *POST* equals zero for nonenacting countries.
NI	Net income before extraordinary items scaled by beginning-of-period market value of equity.
RET	Buy-and-hold stock returns over the fiscal year.
NEG	A binary indicator equal to one if *RET* is less than zero, and zero otherwise.
SIZE	The natural logarithm of total assets.
MTB	The market value of equity divided by book value of equity.
LEV	Total debt divided by total assets.
RETVOL	Standard deviation of daily stock returns over the fiscal year.
Variables used in additional tests	
ACCRUEDXP	Accrued expenses divided by net sales.
BADDEBT	Provisions for uncollectible accounts receivable divided by net receivables.
CASH	Total cash divided by total assets.
COLLATERAL	A binary indicator equal to one if the loan is secured by collateral, and zero otherwise.
COVENANT	The total number of covenants present in the loan contract.
INTCOVERAGE	Earnings before interest and taxes (EBIT) divided by interest expense.
INVEST	Capital expenditures divided by beginning-of-period property, plant, and equipment.
LOANSIZE	The natural logarithm of the dollar amount of loan.
LOSS	A binary indicator equal to one if net income is negative, and zero otherwise.
MATURITY	The natural logarithm of loan maturity in months.
MERGERGROWTH	The difference in the total number of completed mergers and acquisitions between four years before and four years after the enactment year, divided by the total number of completed mergers and acquisitions in the four years before the enactment year.
PPENT	Net property, plant, and equipment scaled by total assets.
PPS	CEO pay-performance sensitivity at the country-year level, measured as the estimated coefficient on industry-adjusted firm return on assets in a regression relating the natural logarithm of total annual CEO compensation (in 2005 U.S. dollars) on industry-adjusted firm return on assets as well as firm-level controls (log assets, leverage ratio, market-to-book ratio, and daily stock return volatility over the year) for all firms in a country year.

APPENDIX B–*Continued*

Variable	Definition
REVOLVE	A binary indicator equal to one if the loan is a revolving line of credit, and zero otherwise.
SG&A	Selling, general, and administrative expenses divided by net sales.
SHRPROTECT	The product of the antidirector rights index from Djankov et al. [2008] and the rule of law index from La Porta et al. [1998] divided by 10.
SPECIALITEM	Special items divided by market capitalization (multiplied by 100).
SPREAD	The natural logarithm of the all-in-drawn spread (in basis points), defined as the interest margin over London Interbank Offered Rate (LIBOR) or a LIBOR equivalent for each dollar drawn down plus annual facilities fees.
STDCFO	Standard deviation of operating cash flows over the past five years.
STDSALE	Standard deviation of sales revenue over the past five years.
ZSCORE	The modified Altman's *z*-score, calculated as $3.3\frac{EBIT}{total\ assets} + 1.0\frac{sales}{total\ assets} + 1.4\frac{retained\ earnings}{total\ assets} + 1.2\frac{working\ capital}{total\ assets}$.
Variables for alternative conservatism measures	
ΔCF	Change in operating cash flows scaled by lagged total assets.
$D\Delta CF$	An indicator variable equal to one if ΔCF is less than zero, and zero otherwise.
ACC	Total accrual (earnings before extraordinary items less cash flow from operations) scaled by beginning of period total assets. This measure is used as the dependent variable in the piecewise linear accrual-cash flow change model of Ball and Shivakumar [2006].
ACC_MV	Total accrual (earnings before extraordinary items less cash flow from operations) scaled by beginning of period market value of equity. This measure is used as the dependent variable in the accrual asymmetry model, proposed by Collins, Hribar, and Tian [2014].

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