

Original Paper

Determinant of Preemptive Corporate Restructuring

Joohyun Lim^{1*}

¹ Baewha Women's University, Jongno-gu, Seoul, South Korea

* Joohyun Lim, Ph.D., Assistant Professor of Tax Accounting, Baewha Women's University, 34 Pillun-daero 1-gil, Jongno-gu, Seoul 03039, South Korea

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Abstract

In this paper, I investigate whether companies with high quality accounting information carry out preemptive corporate restructuring or not. I find the higher the quality of accounting information, the more proactive the corporate restructuring for the following reasons. First, Board of Directors overseeing the management basically identifies the financial position and performance of the entity through accounting information, it will encourage the management to make preemptive restructuring decisions when it is necessary to improve its operating performance or improve its financial structure through corporate restructuring such as the sale of assets, interests, affiliates and business units. Second, high-quality accounting information will play a role in enhancing possibility of completion of corporate restructuring. This finding suggests that high quality of accounting information was required as a determinant that could enhance the practicability of preemptive restructuring.

Keywords

preemptive corporate restructuring, corporate restructuring, accounting information quality

1. Introduction

Corporate restructuring refers to adjusting the size of a business through the sale of assets, interests, affiliates and business units. Corporate restructuring concentrates the core competencies of the entity through the specialisation of the business, which may lead to an increase in the value of the entity. In Korea, the foreign exchange crisis has led to the restructuring of domestic companies, mainly financially troubled companies. However, when an entity is in financial trouble, the value of the entity rapidly declines over time, so it is difficult to expect a positive effect on the value of the entity if it carries out the restructuring after the detection of the financial difficulties. Thus, even before financial difficulties are detected, it is necessary for an entity to carry out preemptive restructuring for reasons

such as improving its financial structure due to the repayment of a liability, securing investment funds in a new investment meeting, improving its operating performance and securing liquidity.

Therefore, this paper was based on the importance of entering into proactive restructuring before the entity becomes insolvent. However, it is difficult for management to make preemptive restructuring because there are few reasons for the decision to reduce the size of the company through restructuring such as the sale of shares and asset sales. This is because, in relation to the issue of agency problem between management and shareholders, the management intends to avoid downsizing the company through corporate restructuring because it has an incentive to expand the company to increase private profits, such as power or prestige, through the expansion of the size of the entity (Jensen, 1986; Stulz, 1990). However, companies with high quality accounting information are expected to carry out preemptive restructuring for the following reasons. First, the management may avoid corporate restructuring due to the agent problem, but if the quality of the accounting information is high, the monitoring role of the management is strengthened, and if restructuring is needed to maximize the value of the enterprise, preemptive restructuring can take place even before a bad sign is detected. Because the Board of Directors overseeing the management basically identifies the financial position and performance of the entity through accounting information, it will encourage the management to make preemptive restructuring decisions when it is necessary to improve its operating performance or improve its financial structure through corporate restructuring. Second, high-quality accounting information will play a role in enhancing possibility of completion of corporate restructuring. In the event of corporate restructuring, the proceeds from the sale of an asset or an interest are determined through a valuation of the asset to be sold. The valuation of the assets to be sold is performed not only by the sale entity but also by the purchase entity, which often results in a delay or failure to sell because of differences in the proceeds of the sale between the two companies. The reason for disagreement with the proceeds of the sale is the difference in the valuation of the asset for sale, which arises when uncertainty is high about the future cash flows of the asset. Dechow (1994) and Subramnyam (1996) showed that the accrual of accounting information provides useful information when predicting future cash flows. Consequently, the valuation of the asset is basically performed through accounting information, and if the quality of the accounting information is low, it is difficult to estimate the future cash flows, which makes it difficult for a purchase entity to measure the value of the asset or interest. That is, because of the increasing uncertainty about the entity's future performance distribution, the buyer firm would lower the purchase price as a compensation for uncertainty, which could be an unacceptable amount of proceeds from the sale for restructuring firms. These disagreements over the proceeds between the purchase firm and sale entity reduce the likelihood of the completion of the restructuring. However, the higher the quality of the accounting information, the less uncertainty about the future cash flows of the entity's assets to be sold, the less disagreement between the selling entity and the buying entity, which increases the likelihood of the asset being sold.

This study analyzed preemptive restructuring of listed Korean companies from 2006 to 2013. Preemptive restructuring was defined as an asset sale and a sale of more than 20 percent of an equity interest, even though it was not financially troubled. Financial difficulty was determined by the debt-to-equity ratio of the entity. I found that the higher the quality of accounting information, the more proactive the corporate restructuring. In other words, the quality of high accounting information is a determinant of preemptive restructuring. A company needs preemptive restructuring in order to solidify its value, even if it is not financially in a difficult position. Such preemptive restructuring, which is essential to the entity, is avoided by the management's agent problem and also results in a delay or failure to complete the corporate restructuring process due to disagreement over valuation of the assets to be sold between purchase firm and sale firm. However, this study shows that entities with a high quality of accounting information tend to carry out more preemptive restructuring because of their effective monitoring role and easier valuation of the assets sold. This paper demonstrated the need for a high quality of accounting information as an essential requirement to increase the feasibility of preemptive restructuring, which is important for the long-term survival and growth of the enterprise. Section 2 presents prior study and the hypotheses and Section 3 presents the details of the sample and research design. Section 4 describes the results, and Section 5 concludes.

2. Prior Study and the Hypotheses

2.1 Prior Study

(1) Financial Reporting Quality

Accounting information becomes an important source of information for investors (Bushman & Indjejikian, 1993). Accounting information is used by shareholders to monitor management (Bushman & Smith, 2001; Lambert, 2001). According to Dechow (1994) and Subramnyam (1996), Accruals provide useful information for predicting future cash flows. Leuz and Verrecchia (2000) showed that the quality of accounting information increases investment efficiency and increases expected cash flows through a model that considers the quality of accounting information and its relevance to cash flows. Healy and Palepu (2001) and Bushman and Smith (2001) also reported that accounting information with high quality increases the investment efficiency of a firm. This is because the higher the quality of accounting information, the less market friction such as moral hazard and reverse selection, the more efficient the investment.

Lim et al. (2015) who studied the quality of accounting information and mergers and acquisitions, a large-scale corporate investment activity, found that high quality of accounting information of the acquiree in mergers and acquisitions increases the acquisition performance of the acquired entity. This is because the high quality of the accounting information of the acquiree reduces uncertainty about the future value of the acquiree and therefore results in appropriate purchase payments. De Franco et al. (2011) showed that if an auditor of an acquiree is a large auditor, the discount on the proceeds of the sale of the acquiree would decrease, thereby increasing the proceeds of the sale. Accounting

information audited by large auditors transparently reflects the financial position and management performance of the entity, thereby reducing the discount phenomenon by reducing the information asymmetry between the acquired and the acquirer.

In summary, the preceding studies show that a high quality of accounting information can reduce information asymmetry and reverse selection costs for an investor or purchaser. From the perspective of a selling company, it can be seen that high quality accounting information can reduce the discount of the proceeds from the sale of the assets it sells so that selling firm receives the appropriate proceeds from the sale.

(2) Corporate Restructuring

Previous research on corporate restructuring can be categorized under three main themes. First, it is related to finding out the determinants of corporate restructuring. Rosenfeld (1984) suggested that an entity has an incentive to sell assets to improve operating efficiency and performance, and it seeks to eliminate the synergistic effects of negative sales. Park and Paik (2009) showed that companies with large scale, high systemic risks, lack liquidity and high debt ratios tend to do corporate restructuring such as disposition of securities and shares, sales of assets in real estate, business sectors, factories, etc. Second, there are a lot of previous studies related to the performance of corporate restructuring. Lang et al. (1995) showed that companies with low performance or high debt ratios receive a positive response in the stock market when they sell assets for debt repayment due to improved liquidity. Park and Paik (2009) showed that factors such as corporate size, liquidity index, systemic risk, chaebol ownership status, debt ratio, major shareholder interest rate and foreign equity ratio had a significant positive relationship to the restructuring disclosure effect and long-term performance. John and Ofek (1995), Schlingmann, Stulz and Walking (2002) report positive for firm value when they focus their core competencies on selling assets. Kim and Park (1999) stated that if an entity sells an asset for the purpose of focusing its business, it is positive to the value of the corporate.

Third, prior research on corporate restructuring has been conducted only by workout or court receivership companies. Kim et al. (2013) assessed the performance of corporate restructuring by using management indicators such as capital return and economic value added for companies that applied for court receivership or workout, and there was continuous improvement in the management performance of restructuring companies for five years after the restructuring was carried out. Park and Lee (2017) examined earnings management using accruals for the workout and court receivership companies after corporate restructuring. In a workout company, earnings management using accruals were observed less than those of the court-managed companies. This is because the workout companies have a lower degree of insolvency when they apply for a workout and will be more strictly monitoring their management during corporate restructuring.

The differences between these prior studies and this study are as follows. First, this study seeks to analyse whether the quality of accounting information serves as a determinant of corporate restructuring. Park and Lee (2017) is a leading research that analyzes the quality of accounting

information and the relevance of corporate restructuring, which focuses on changes in the quality of accounting information after restructuring, not on analysis of the quality of accounting information as a determinant of restructuring.

Second, existing studies have been much of a sample of financially troubled companies such as workout and court receivership. However, this study targeted companies that conducted preemptive corporate restructuring through disposition of securities and holding equity, sale of property, plant and equipment, business department sales before it became financially difficult.

2.2 Hypothesis Development

The separation of ownership and management of the entity creates an agent problem between the shareholders and the management. Information asymmetry between shareholders and management results in hidden actions and moral hazard for managers. Moral hazard is a phenomenon in which managers put efforts into pursuing the private interests of managers rather than increasing shareholders' wealth. The agent problem damages the corporate value by producing inefficiency in corporate management.

Prior studies explain that managers have an incentive to seek corporate expansion. The manager wants to increase the size of the company to promote his private utility (Jensen & Meckling, 1976). In addition, management conducts mergers and acquisitions to secure greater decision-making rights for controllable resources and reputations (Jensen, 1986). Some point out that this is related to the ostentatious tendency to focus on appearance rather than on inner reality, and that this is because the management is inherently inclined to the direction of empire building (Schumpeter, 1934; Marris, 1964). Moreover, these managers' desire for corporate growth is related to the size of the company and the compensation of the management (Murphy, 1985; Sanders, 2001).

However, in some cases, reducing the size of an entity is necessary to maximize its value. Companies should cope with changes in economic conditions and technology by expanding or downsizing (Coase, 1937). For reasons such as improving the financial structure due to repayment of liabilities, securing investment funds for new investment meetings, improving operating performance and securing liquidity, the entity needs to carry out restructuring through asset sales, equity sales and corporate restructuring in advance, even before the entity can detect bad signs. However, the management will want to avoid corporate restructuring to reduce the size of the company because it has a desire to expand it. Therefore, the board of directors overseeing the management should be able to induce the management to make corporate restructuring decisions if restructuring is necessary to maximize the value of the business. At this time, accounting information is an integral part of the management's monitoring role. This is because accounting information is an important source of information for an entity for investors (Bushman & Indjejikian, 1993) and is used by shareholders to monitor management (Bushman & Smith, 2001; Lambert, 2001). Higher-quality earnings reports provide more information about the features of a firm's financial performance that are relevant to a specific decision made by a specific decision-maker (Dechow et al., 2010). The Board of Directors, which oversees the

management, also basically assesses the current status of the entity through accounting information, and a high quality of the accounting information enables the entity to correctly assess its financial position and management performance. Therefore, the board of directors of a company with high quality accounting information could encourage management to make corporate restructuring decisions if it is deemed necessary for the entity to carry out a preemptive restructuring even before a financial failure is detected.

H: The higher the accounting information quality of the firm, the higher the likelihood of preemptive corporate restructuring.

3. Sample and Research Design

3.1 Sample Description

A sample of corporate restructuring in this study is an entity that attempted to preemptively restructure itself from 2006 to 2013 by disposing of its holdings as announced in the market and selling assets of real estate, business units and factories in Korea. This study excluded companies that had been subject to restructuring in the form of workout and court receivership. Preemptive corporate restructuring samples were extracted through the S&P Capital IQ database. The financial data were obtained from the Kis-Value database. In addition, financial industry entities whose financial statements are different from other industries were excluded from the sample. To select a controlled firm, 1:1 matching was selected based on the total asset and liability ratio using Propensity Score Matching (PSM) methods, as in Lawrence et al. (2011) and Lennox et al. (2012). Finally, the samples used in this study were 741 preemptive corporate restructuring firms and 741 controlled firms as provided in Table 1. It shows a general increase in the number of acquisitions until 2008, sharp decreases in 2009, and increases again after 2010.

Table 1. Sample Distribution

Year	Preemptive Coporate Restruturing Firms		Control Firms		All firms	
	Number	Percentage	Number	Percentage	Number	Percentage
2007	32	4.32	101	13.63	133	8.97
2008	70	9.45	114	15.38	184	12.42
2009	64	8.64	97	13.09	161	10.86
2010	90	12.15	101	13.63	191	12.89
2011	138	18.62	119	16.06	257	17.34
2012	176	23.75	99	13.36	275	18.56
2013	171	23.08	110	14.84	281	18.96
total	741	100	741	100	1482	100

3.2 Measurement of Accounting Information Quality

The independent variable of this study is the quality of accounting information. I adopt performance-matched discretionary accruals according to the method of Kothari et al. (2005), which is a re-modified version of the modified Jones model. They argue that discretionary accruals are affected by firm performance and therefore include ROA (return on assets) as a variable in the modified Jones model. A discretionary accruals is a measure of earnings management of a firm, and a higher level of discretionary accruals can mean a higher level of earnings management, thus lowering the quality of accounting information. A discretionary accruals are measured by residual from Equation (1). I multiply residuals from Equation (1) by -1 so that this variable increases accounting information quality increases, as described in Equation (2).

$$\frac{TA_t}{A_{t-1}} = \alpha_0 + \beta_1 \frac{1}{A_{t-1}} + \beta_2 \frac{\Delta S_t - \Delta AR_t}{A_{t-1}} + \beta_3 \frac{PPE_t}{A_{t-1}} + \beta_4 ROA_t + \varepsilon_t \quad (1)$$

where TA_t = Net income - cash flow from operations;

S_t = Sales revenue;

AR_t = Accounts receivable;

PPE_t = Plant, property, and equipment;

ROA_t = Net income/total assets; and

A_t = Total assets.

$$AQ_{i,t} = \varepsilon_{i,t} \quad (2)$$

where

AQ = Accounting information Quality

ε = residual from Equation (1)

3.3 Empirical Models

The following equation (3) was established to verify the hypothesis in this study that The higher the accounting information quality of the firm, the higher the likelihood of preemptive corporate restructuring. Logistic regression was performed because the dependent variable consisted of two categories, whether to carry out preemptive restructuring or not. Here, the variable of interest is the quality of the accounting information (AQ), and β_2 is expected to be a positive (+) value if the hypothesis is adopted.

$$\text{Pre_Restructuring}_{i,t} = \beta_1 + \beta_2 AQ_{i,t} + \beta_3 \text{Size}_{i,t} + \beta_4 \text{Leverage}_{i,t} + \beta_5 ROA_{i,t} + \beta_6 OCF_{i,t} + \varepsilon_{i,t} \quad (3)$$

where

Pre_Restructuring: 1 if a firm had implemented preemptive corporate restructuring, and 0 otherwise.

AQ: accounting information quality, discretionary accruals according to the modified Jones model (1991) as described in Equation (2).

Size: firm size, the natural logarithm of total assets of firm at the beginning of the fiscal year.

Leverage: leverage ratio, the book value of debt scaled by the total book value of assets.

ROA: Return on Assets , net income scaled by the total book value of assets.

OCF: operating cash flow, operating cash flow from cash flow statement scaled by the total book value of assets.

The dependent variable, preemptive corporate restructuring (Pre_Restructuring), is a dummy variable coded as 1 if a firm had implemented preemptive corporate restructuring, and 0 otherwise. The independent variable, accounting information quality (AQ), is discretionary accruals according to the modified Jones model (1991), as discussed in Section 3.2.

I include four control variables, size (Size), leverage (Leverage), Return on Assets (ROA) and operating cash flow (OCF). I define firm size as the log transformation of the total assets. I control for leverage in the model, measuring it as total liability divided by assets. I define ROA as the ratio of net income divided by assets and OCF as the ratio of operating cash flow from cash flow statement divided by assets.

4. Results

4.1 Descriptive Statistics and Correlations

Table 2 lists the descriptive statistics resulting from hypothesis testing. Panel B of Table 2 presents the descriptive statistics of preemptive corporate restructuring firms and Panel A of Table 2 shows that of control firms. The mean and median values of the accounting information quality (AQ) for preemptive corporate restructuring firms are 0.0128 and that for control firms are 0.0035 respectively meaning that accounting information quality of preemptive corporate firms is higher than that of control firms.

Table 2. Summary Statistics

Panel A. All firms						
Variable	N	Mean	Median	StdDev	Min	Max
AQ	1482	0.0081	0.0119	0.1214	-0.4128	0.3707
Size	1482	27.2398	27.1386	1.9839	22.9749	30.5326
Leverage	1482	1.2295	0.8381	1.3436	0.0206	7.0970
ROA	1482	0.0137	0.0304	0.1239	-0.5755	0.2710
OCF	1482	0.0439	0.0411	0.0888	-0.2446	0.3347
Panel B. Preemptive Corporate Restructuring Firms						
Variable	N	Mean	Median	StdDev	Min	Max
AQ	741	0.0128	0.0182	0.1319	-0.4128	0.3707
Size	741	27.2391	27.1421	1.9823	22.9749	30.5326
Leverage	741	1.2243	0.7166	1.4239	0.0206	7.0978
ROA	741	-0.0028	0.0239	0.1447	-0.5755	0.2710
OCF	741	0.0339	0.0333	0.0866	-0.2446	0.3347

Panel C. Control Firms						
Variable	N	Mean	Median	StdDev	Min	Max
AQ	741	0.0035	0.0067	0.1099	-0.4128	0.3707
Size	741	27.2406	27.1317	1.9868	22.9749	30.5326
Leverage	741	1.2347	0.9279	1.2592	0.0206	7.0978
ROA	741	0.0303	0.0372	0.0960	-0.5755	0.2710
OCF	741	0.0538	0.0502	0.0900	-0.2446	0.3347

AQ: accounting information quality, discretionary accruals according to the modified Jones model (1991) as described in Equation (2), Size: firm size, the natural logarithm of total assets of firm at the beginning of the fiscal year,

Leverage: leverage ratio, the book value of debt scaled by the total book value of assets,

ROA: Return on Assets, net income scaled by the total book value of assets,

OCF: operating cash flow, operating cash flow from cash flow statement scaled by the total book value of assets.

Table 3 presents Pearson correlations. The likelihood of preemptive corporate restructuring is negatively correlated with return on assets (ROA) and operating cash flow (OCF).

Table 3. Pearson Correlation Matrix

	AQ	Size	Leverage	ROA	OCF
Pre_Restructuring	0.0382	-0.0003	-0.0038	-0.1333***	-0.1118***
AQ		0.0944***	0.0129	0.1061***	0.26***
SIZE			0.139**	0.1684***	0.1506***
Leverage				-0.2636***	-0.1970***
ROA					0.4049***

1) Pre_Restructuring: 1 if a firm had implemented preemptive corporate restructuring, and 0 otherwise.

Other variables are defined in Table 2.

2) *** indicates significance at the 1% level, ** at the 5% level, and * at the 10% level.

4.2 Logistic Regression Analysis

Table 6 reveals the results of the logistic regression analysis based on the estimation in Equation (3) related to hypothesis, which examines the higher the accounting information quality of the firm, the higher the likelihood of preemptive corporate restructuring. As predicted in hypothesis the coefficients of accounting information quality (AQ) are positive and significant at the 1% level. This result suggests that the higher the quality of accounting information, the more proactive the corporate restructuring. In other words, the quality of high accounting information is a determinant of preemptive restructuring. A

company needs preemptive restructuring in order to solidify its value, even if it is not financially in a difficult position. Such preemptive restructuring, which is essential to the entity, is avoided by the management's agent problem and also results in a delay or failure to complete the corporate restructuring process due to disagreement over valuation of the assets to be sold between purchase firm and sale firm. However, this result shows that entities with a high quality of accounting information tend to carry out more preemptive restructuring because of their effective monitoring role and easier valuation of the assets sold.

Table 4. Financial Reporting Quality and Preemptive Corporate Restructuring

$\text{Pre_Restructuring}_{i,t} = \beta_1 + \beta_2 \text{AQ}_{i,t} + \beta_3 \text{ROA}_{i,t} + \beta_4 \text{OCF}_{i,t} + \beta_5 \text{Size}_{i,t} + \beta_6 \text{Leverage}_{i,t} + \varepsilon_{i,t}$		
	Coeff.	Wald Chi-Square
Intercept	-0.8305	1.2356
AQ	1.3091	7.8349***
Size	0.0396	2.0222
Leverage	-0.1005	5.5201**
ROA	-2.2074	17.2271***
OCF	-2.3054	10.9883***
N	1482(741+741)	
R ² (%)	3.13%	

1) Pre_Restructuring: 1 if a firm had implemented preemptive corporate restructuring, and 0 otherwise. Other variables are defined in Table 2. 2) *** indicates significance at the 1% level, ** at the 5% level, and * at the 10% level.

5. Conclusion

In the past, companies attempted to invest heavily in expanding the size of companies through mergers and acquisitions (M&A) for economies of scale. Recent companies, however, are focusing on optimizing their size through corporate restructuring such as selling assets, selling subsidiaries and selling noncore affiliates to focus their corporate capabilities. Therefore, even before financial difficulties are faced, a company should be able to actively attempt preemptive voluntary restructuring to improve its operating performance and its financial structure. The revitalization of corporate restructuring is also a desirable direction in terms of revitalizing the local capital market. This study showed that high quality of accounting information was required as a determinant that could enhance the practicability of preemptive restructuring, which is essential for the long-term survival and growth of the enterprise. I hope that the results of this study will provide an opportunity for an entity to continue to strive for high quality accounting information.

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Note

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