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# Implications of strategic alliances for earnings quality and capital market investors ☆

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ABSTRACT

Strategic alliances are well-established organizational forms and a means of strategy implementation. Despite their growing pervasiveness in the economy, existent literature provides few insights about earnings quality of strategic alliances. This challenge is especially severe in contractual alliances (CAs), where firms do not form a new corporate entity that is separate from the parent organization in comparison to joint ventures (JVs). We investigate how earnings attributes differ depending on involvement in strategic alliances of 8137 CAs and 3026 JVs spanning 1997–2007. We find, in particular, that earnings attributes of firms involved in contractual alliances are broadly reflective of low underlying accounting quality. Relative to JV firms and non-alliance (NA) firms, they have higher levels of discretionary accruals, lower accrual quality, and earnings that are less persistent, less smooth, less relevant, less timely, and less conservative. They also have lower earnings response coefficients.

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## 1. Introduction

Strategic alliances are voluntarily initiated cooperative agreements between firms that involve exchanging, sharing or co-developing resources or firm-specific assets (Li, Qian, & Qian, 2012). Firms enter strategic alliances to minimize costs that stem from coordination difficulties, to access other parties' resources, to acquire institutional knowledge, and to retain and develop own resources by combining them with those of partners' (Chan, Kensinger, Keown, & Martin, 1997).

In this study, we tackle the broad question of how firms' earnings quality differs depending on their involvement in strategic alliances. Despite growing pervasiveness of strategic alliances the existent literature provides few insights about the impact of strategic alliances on firms' earnings. This impact is particularly important for firms' strategy since firms' earnings is a significant indicator of firm performance. In particular, alliances often involve an ongoing intermingling of the operations, such as of reporting behaviors, of two or more "independent" entities. Hence, the economic performance of one involved entity now depends partly on the well-being of its partner(s). Moreover, while the overall alliance constitutes an arms-length agreement, the structuring of individual transactions and allocations within it may involve various informal quid-pro-quo arrangements among the partners. These tradeoffs have substantive implications for periodic financial accounting reports. In such cases, strategic alliance arrangements may blanket various opportunistic and short-run earnings management activities.

Using earnings quality metrics established in the literature (Velury & Jenkins, 2006) we explore the earnings quality of (1) firms involved in joint venture alliances (JV), and (2) firms involved in contractual alliances (CA). Specifically, we evaluate whether earnings attributes differ between firms with joint ventures (JV-firms) and firms with contractual alliances (CA-firms), as well as between such alliance firms and firms without any recent alliance activity (i.e., non-alliance or NA-firms). Our findings broadly support that firms involved in CA earnings exhibit inferior attributes relative to either JVs or NAs. However, JVs and NAs are indistinguishable for most of the earnings quality attributes examined. Although managers of CA-firms provide more quantitative and qualitative voluntary earnings reports, i.e. voluntary disclosure, than that of all other firms including JV-firms and NA-firms to decrease the premium that investors demand because of poorer information quality environment, when the alliance is not formalized and largely unreported, there is still an evidence of a substantive relative impairment in earnings quality.

## 2. Literature review

Strategic alliances accomplish preset objectives such as increasing efficiency and creating competitive advantages while avoiding both market uncertainties and hierarchical rigidities. Strategic alliances may be formalized as JVs in which the joint activities are compartmentalized

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into a separate stand-alone entity or they may be left comparatively undefined and intertwined, a state we identify as CAs. Partner firms share benefits and managerial control over the performance of assigned tasks, and make continuing contributions to one or more strategic areas, such as technology or product development. Partner firms in a strategic alliance remain legally independent after the alliance is formed (Yoshino & Rangan, 1995). Chan et al. (1997) observe that CA-firms do not share equity controls, but they fulfill their responsibilities and contribute to the partnership with their resources, such as high technology, products and/or skills, product design, delivery schedules, prices and other terms. Moreover, CAs do not prepare financial reports or file tax returns individually. Thus, in most cases any detail related to the individual activities of contractual alliances is not available for external users or the public.

Anand and Khanna (2000) recognize alliances as complex organizational types with incomplete contracts that are open to all kinds of informational noise, and managerial discretions. Alliance setting is a fertile environment for opportunistic managers and directors to exercise their personal interests through their accounting choices. Two control problems arise with firms involved in alliances: (1) the management of appropriation concerns that result from partner firm's opportunistic behaviors, and (2) the coordination of tasks by building on transaction cost economics and organizational theory.

Evidence on market reaction to the formation of either CA or JV is limited. Das, Sen, and Sengupta (1998) documented that, on average, abnormal returns are positive and statistically significant when there is a strategic alliance announcement. By partitioning the sample into marketing and technological alliances, they found that overall positive abnormal returns are attributable to technological alliances. Chan et al. (1997) documented positive price reaction to the formation of CA without evidence of wealth transfer. McConnell and Nantell (1985), Koh and Venkatraman (1991) and Woolridge and Snow (1990) found abnormal positive returns around the time that the JV agreements were announced.

## 3. Research issues

In many cases, the economic performance of strategic alliances is difficult to discern from the involved firm. While this coupling is formal in JVs, it may impair the quality of their financial reporting. This is especially so in CAs where the intertwining is informal, because joint activities are not compartmentalized. These reporting techniques may create allocation problems when each partner needs to report their financial transactions individually.

Separating financial activities of the partner firm's entities from those of the strategic alliances has been an ongoing challenge for accounting practitioners both in terms of financial and tax reporting issues (Wallman, 1995). There is also no standard reporting requirement regarding the strategic alliance activities of firms (Healy & Palepu, 2001). Hence, we examine the relationship between earnings quality and either JV or CA involvement. Our explanatory study provides insights into whether such arrangements are generally benign, with no substantive externally observable financial reporting implications; or consistent, with alliance driven reporting consequences that affect the quality of externally reported financial information.

### 3.1. Financial reporting aspects of strategic alliances

In most cases, the economic performance of a firm involved in strategic alliances is coupled with its alliance partners. For example, it is difficult for financial statements to fully reflect the exclusive contracts that underlie strategic alliance relations between Steve Madden and its manufacturers. Because of its alliances, Steve Madden has been able to outsource the low margin activities for its business. However, the reported financial performance of Steve Madden does not fully reflect the complex relationship and implicit commitments between the companies. Therefore, distortions to any of the accounting numbers and allocations related to contractual alliances and joint ventures may create inherent problems and noise in the financial statements of the partnering firms. Especially in CAs where, activities of the allied firms are completely intermingled, such economic activities by each firm must be separated for individual financial reporting. This separation process, even if conducted in “good faith”, could lead to substantial distortions in the financial reports of allied firms. This would make it difficult for the preparers and users of financial reports to distinguish the individual activities of allied firms accurately. For example, CAs and allied firms often share common resources such as information technology, legal services, human resource management and executive time. Common cost allocation of these resources is difficult when undertaken as an explicit exercise (Ray, 2007). In less formal CA settings common costs may entirely escape from explicit accounting attention and may simply fall out of the affiliated company's financial statements. In a similar fashion, consolidating JV financials with those of the parent firms may also create accounting problems when the JV and its parent firms use different accounting methods.

The fundamental conflict posed by strategic alliances concerns the viability of treating them as independent entities. The very nature of a strategic alliance implies mutual dependence. In CAs, the issue is compounded by the fact that, unlike JVs, the alliance is not a compartmentalized organization with its own separate accounting system. That is, CAs rely on the allied firms' accounting systems, therefore the financial information/performance of CAs is non-systematically and non-observably aggregated into the parent firm financial reports. Alternatively, JVs generate separate financial reports based on a JV-specific accounting system for their partners and interested parties. Therefore, this joint activity is observable and transparent in the case of JVs. Moreover, income impacts are allocated to partners based on the JV agreement making them observable to external parties. Hence, while interdependence characterizes both forms of strategic alliances they differ markedly in terms of the underlying accounting mechanics.

Unlike JVs, where parent firms establish a separate organizational unit with established accounting and controlling systems, in CAs there are no such regulatory requirements (Healy & Palepu, 2001). Absence of such a mandated disclosure may contribute more to the noisiness of the reporting of CAs. However, from a market-based point of view (Core and Guay, 2001), firms may need to respond to investors' information demand when accounting data is less useful in assessing firm value and informing the market. In order to do so, CA-firms provide more remedial quantitative and qualitative data in the form of voluntary disclosures than JV-firms and NA-firms such as non-financial discussions in their reporting. This finding may be due to a response to investors' information demand when accounting data is less useful in assessing firm value accurately. In other words, although not required legally, especially we observe more voluntary disclosure of qualitative information in CAs. Such a remedy targeted towards increasing the accounting based reporting quality may eventually decrease noise in accounting reporting of CA-firms. Table 1 provides some useful insights about the financial reporting attributes of JVs and CAs.

JV-firms commonly provide joint activity information in both the Management Discussion and Analysis and the financial reporting sections of their annual reports. In some cases, they also provide complete financial statements showing how each transaction affects the main business activities of the parent firms. CA-firms generally do not provide quantitative financial information about their partnership activities. However, they tend to provide information regarding the strategic influence of the alliance on the firm, and the purpose behind establishing CAs.

Panel A of Table 1 is based on our examination of firm financial reports (i.e., annual reports and 10Ks) of 100 randomly selected JV-firms and CA-firms. This table provides a breakdown of the fundamental joint activity(ies) encompassed by the strategic alliance for JV and CA samples. For JV-firms revenue sharing (43 firms), operating cost sharing

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