Available online at www.sciencedirect.com
SCIENCE DIRECT
ELSEVIER
Journal of Accounting and Economics 39 (2005) 411–436
JOURNAL OF Accounting & Economics
www.elsevier.com/locate/jae

Operating performance following open market share repurchase announcements ☆

Erik Lie*

Henry B. Tippie College of Business, University of Iowa, Iowa City, IA 52242-1000, USA

Available online 1 June 2005

Abstract

I document that operating performance improves following 4,729 announcements of open market share repurchase programs from 1981 to 2000. Moreover, the capital market responds favorably to earnings announcements after the program announcements. Further analysis reveals that both the operating performance improvement and the positive earnings announcement returns are limited to those firms that actually repurchase shares during the same fiscal quarter. Last, I report that a subsample of firms that initiate the repurchases in quarters following the program announcements experience improvements after the initiation quarter, suggesting that actual repurchases, and not announcements per se, portend future performance improvements.

JEL classification: G35

Keywords: Share repurchase; Operating performance

1. Introduction

The last two decades have witnessed a dramatic increase in the use of open market repurchases, and by 1998 the total value of share repurchases (led by open market

☆I thank Heidi Lie, an anonymous referee, and the editor (Ross Watts) for helpful comments.
*Tel.: 319 335 0846; fax: 319 335 3690.
E-mail address: erik-lie@uiowa.edu.

0165-4101/$ - see front matter
doi:10.1016/j.jacceco.2005.04.001

repurchases) exceeded that of dividends (Grullon and Michaely, 2002). According to the survey evidence in Brav et al. (2003), managers regard undervaluation of the stock to be the most important reason for repurchasing shares. If the stock is truly undervalued, share repurchase programs represent positive NPV projects that benefit shareholders. Any undervaluation likely stems from managers expecting future operating performance to be better than the capital market expects. Thus, a side effect of share repurchases is that they convey favorable information to the market about future performance.

Consistent with the notion that open market share repurchases convey favorable information to the capital market, Vermaelen (1981) and Comment and Jarrell (1991) report that the stock market reaction to announcements of open market share repurchase programs is positive. Bartov (1991) provides some evidence that the positive wealth impact is attributable to an improvement in earnings. In particular, he reports that analysts revise upward their earnings forecasts around open market share repurchase announcements relative to control firms and that earnings improve during the announcement year. However, using a much larger sample, Grullon and Michaely (2004) find no evidence that analysts revise their earnings forecasts upward around open market share repurchase program announcements, and only weak evidence that earnings improve during the announcement year. In addition, neither Bartov nor Grullon and Michaely find any evidence of earnings improvements during post-announcement years. Overall, there is little evidence in extant literature that announcements of repurchase programs portend improvements in operating performance. If there is an improvement, it appears to primarily take place during the announcement year. It is difficult, however, to interpret any changes during the announcement year, because they might occur during the fiscal quarters before the announcement or the fiscal quarters afterward. This distinction is important, because it might tell whether decisions to launch open market repurchase programs depend on insiders' expectations of future performance changes and whether performance changes can explain the positive average stock price reaction upon program announcements.

I reexamine changes in operating performance around open market repurchase program announcements using quarterly data. Quarterly data permit me to better disentangle changes in performance immediately before and after the announcements. In addition to reporting performance changes for firms that announce repurchase programs and performance changes net of corresponding changes for industry peers, I report performance changes net of changes for firms with similar pre-event performance. Fama and French (2000) show that past performance patterns affect future performance changes. For example, a firm with superior performance will likely experience a subsequent reversion to the industry norm as other firms imitate its strategy and products. As a result, Barber and Lyon (1996) and Lie (2001) report that when analyzing whether future performance changes unexpectedly for firms with superior performance, the failure to compare the performance changes to those for firms with similar past performance generates biased test-statistics. Because firms that announce repurchases generally exhibit superior performance, I primarily rely on the changes for the sample firms net of the