Security Market Reaction to Purchase Business Combinations at the First Earnings Announcement Date

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Accounting for purchased goodwill in mergers and acquisitions has been a hotly debated issue for many years because of the increasingly large impact of goodwill amortization on the reported earnings of acquiring firms and its implications for the subsequent performance of the combined entity. There is evidence that top management of firms seeking to acquire other companies attempts to avoid purchase accounting when possible to avoid the hit to earnings associated with goodwill amortization. However, since there may be no economic cash flows associated with the goodwill amortization, it is not immediately apparent that the required goodwill amortization has a negative effect on stock prices. This study examines the extent to which increases in purchased goodwill are negatively associated with the security prices of acquiring companies at the time of the first earnings announcement following the completion of the merger. The results indicate that firms exhibit negative abnormal returns around the first quarterly earnings announcement date following a purchase business combination and that the size of the reaction is negatively related to the amount of goodwill associated with the purchase. Thus, the results support the concerns expressed by the financial press that reporting large amounts of goodwill is bad news at the time of earnings announcements. These results are not inconsistent with the findings of earlier work suggesting that goodwill is positively valued by the market. Rather, our results suggest that while goodwill may be viewed positively as an asset, the earnings impact of the amortization of goodwill is bad news to the market.

When Paramount Communications failed in its $11 billion bid to purchase Time in 1989, one often cited reason was that the deal would have included $9.2 billion of accounting goodwill. This staggering load was expected to depress the earnings of the acquiring company—and its stock price—for years to come (McGoldrick, 1997, p. 145).

1 The intangible asset goodwill can only arise when a business combination is accounted for by the purchase method. If any cash is paid for the acquisition, the purchase method, rather than the pooling-of-interests method, combination is required. U.S. accounting rules require that the goodwill be amortized over its useful life but not more than 40 years. However, prior to the Revenue Reconciliation Act of 1993 (OBRA 93), the Internal Revenue Code did not allow for the amortization of goodwill for tax purposes. Consequently, the required amortization of goodwill implemented in 1970 by APB Opinion No. 17 penalized reported earnings but had no direct cash flow effects. Even now, not all goodwill can be amortized for tax purposes. Goodwill amortization for tax purposes requires that the business combination be taxable.
In another example, Gillette Company acquired Duracell International Inc. in a stock-swap intentionally structured as a pooling-of-interests. A report of the deal emphasized how accounting rules seemed to motivate management’s behavior:

Gillette executives deliberately structured the deal to cater to Wall Street’s simplistic emphasis on reported earnings per share. They chose an accounting treatment that would appeal to the Street—even though it may cost shareholders more money. So important was the accounting strategy that one Gillette adviser says the company would have walked away had Duracell insisted on a cash deal (Maremont, 1996, p. 36).

Proponents of the perception that the required amortization of goodwill is detrimental to company valuation also have asserted that it is affecting the international competitive ability of U.S. firms bidding against foreign firms (An Edge to Foreign Buyers?, 1988; Dieter, 1989; Wechsler, 1989b; Davis, 1992). However, despite the concerns voiced by the financial press, no empirical evidence has substantiated that the non-cash write-off to earnings caused by goodwill amortization negatively impacts stock prices. Davis (1996, p. 58) reviews extant literature and concludes that, “There is thus no reason for firms to hide goodwill and, as yet, no conclusive evidence that the non-cash reduction in reported income caused by goodwill amortization harms stock prices.”

This study examines this issue. Specifically, we examine the extent to which increases in purchased goodwill are negatively associated with the security prices of acquiring companies at the time of the first earnings announcement following the completion of the merger. The results indicate that firms exhibit negative abnormal returns around the first quarterly earnings announcement date following a purchase business combination and that the size of the reaction is negatively related to the amount of goodwill associated with the purchase. Thus, the results support the concerns expressed by the financial press that reporting large amounts of goodwill is bad news at the time of earnings announcements. These results are not inconsistent with the findings of earlier work suggesting that goodwill is positively valued by the market. Rather, our results suggest that while goodwill may be viewed positively as an asset, the earnings impact of the amortization of goodwill is bad news to the market.

The remainder of this article is structured as follows. In the next section, previous literature examining the market response to goodwill disclosures is examined. Then, the research hypotheses are developed. The fourth section discusses the methodology and presents the results. The final section summarizes the results and presents conclusions.

Prior Literature

Hong, Kaplan, and Mandelker (1978) compared tax-free poolings and purchases over the period 1954–1964 and found no evidence that abnormal returns were negative for firms using the purchase method during the period after the merger. Using a sample of 97 poolings and 27 purchases, the authors examined abnormal stock returns by using the market model and monthly returns for the period from 12 months before the merger date until 11 months after the merger date. The results indicated generally insignificant returns for firms using poolings and positive abnormal returns in the post-announcement period for purchase acquisitions. Davis (1990) replicated Hong, Kaplan, and Mandelker over the 1971–1982 time period by using weekly returns and found similar results. Both of these studies focused on average market reactions of pooling and purchase firms relative to the merger announcement date.

In contrast, in this study we focus on returns during the period surrounding the first earnings announcement following the merger and its relation to goodwill amortization. Davis (1990), Robinson and Shane (1990), and Vincent (1997) provided evidence that merger premia are greater for poolings than purchases. These findings are consistent with the reluctance of acquiring firms to book large amounts of goodwill. That is, in cases where it is likely that goodwill is greatest, it appears that efforts are made to structure the combination as a pooling of interest. Vincent concluded that there is support for the concern that purchase method accounting has negative valuation implications.

Several studies provide evidence that goodwill values are viewed as assets by the market (e.g., Vincent, 1997; Wang, 1993; McCarthy and Schneider, 1995; Jennings, Robinson, Thompson, and Duvall, 1996). Jennings, Robinson, Thompson, and Duvall examined the relation between equity values and reported goodwill for the period 1982–1988. They found that when goodwill was regressed against the market value of equity, a strong positive relation was found for each of seven years after the acquisition. The size of the coefficient decreased each year consistent with goodwill being a wasting asset. Jennings, Robinson, Thompson, and Duvall also examined the relation between market values and goodwill amortization in the seven post-merger years. The results are mixed depending upon the form of the model but provide some evidence that goodwill amortization is negatively associated with market value.

Summarizing the status of current research findings, it appears that reported goodwill is viewed as an economic resource by market participants, but at the same time, there is evidence that the unreported goodwill associated with pooling-of-interest accounting is even higher. This is consistent with the hypothesis that managers concerned with the negative hit to earnings associated with goodwill amortization will expend resources to avoid this cost. While the above studies provide indirect evidence that the goodwill amortization would be expected to be associated negatively with returns, they do not directly test this conjecture.

From a policy perspective, it is important to determine if in fact, the hit to earnings associated with goodwill amortiza-
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