THE VALUE-RELEVANCE OF CURRENT AND FORWARD-LOOKING ACCOUNTING INFORMATION SUBSEQUENT TO A CORPORATE RESTRUCTURING

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ABSTRACT

When a company recognizes a restructuring charge, current operating earnings are reduced by the accrued estimated costs of a typically multi-year restructuring plan. Given the magnitude and non-recurring nature of the charge, analysts and the popular press often attempt to remove the effects of the restructuring and focus on pre-charge earnings. Thus, the restructuring phenomenon raises concerns about the value-relevance of fundamental accounting data. This paper investigates this issue by assessing the value-relevance of both current and forward-looking accounting information for a sample of restructured firms. We use a residual income valuation model that is based on book value and projected abnormal earnings to uniquely capture the accounting dynamics of the restructuring event. The explanatory power of this valuation model is consistently higher than models based on current earnings even after controlling for the non-recurring charge. The results also indicate that the

Advances in Accounting, Volume 18, pages 195–220.

ISBN: 0-7623-0719-6

value-relevance of earnings declines following a restructuring, while the forward-looking information marginally increases in explanatory power. These results suggest that subsequent to a restructuring, investors price the dissipation of owners' equity reflected in current book value and augment that book value with more forward-looking accounting information consistent with the residual income model.

INTRODUCTION

This paper investigates the value-relevance of current and forward-looking accounting information following a corporate restructuring, an event which may severely disrupt the earnings process and obscure its information content. In a typical corporate restructuring, the firm attempts to streamline operations by disposing of nonproductive assets and/or workforce reductions. The estimated costs of such multi-year restructuring plans are accrued and charged to current income. Therefore, current year earnings contain a large "non-recurring" component while the uncertain benefits from the restructuring plan (e.g. enhanced operating income) will not be recognized until future periods. Analysts' concerns over the accounting treatment of the restructuring event are reflected in the following comment by Ciesielski (1995) in "The Analyst's Accounting Observer:"

> The obfuscation they [restructuring charges] produce in the determination of income is always the same: the charges in one period do not reflect the activities of only that period. Reported future earnings tidily exclude any expenditures being made that may benefit those periods.

Therefore, financial analysts and investors attempting to value a firm may perceive accounting earnings as less relevant following a restructuring due to severe matching problems.

Prior research suggests that large write-offs tend to diminish the value-relevance of current year earnings, even after removing the special charges against current income (Elliott & Hanna, 1996). Other research suggests that the value-relevance of book values increases in the presence of one-time charges (Collins et al., 1997; Jennings et al., 1998). While these studies address the value implications of historical cost accounting data from the current financial reporting model, the value-relevance of projected future earnings, conditioned by the uncertain impact of a restructuring, has not been examined.

The objective of this paper is to extend prior research by applying a formal valuation model that incorporates current book value as well as forward-looking accounting information to firms that have restructured operations. From an accounting perspective, the restructuring event can be characterized as the