Goodwill and Goodwill
Write-off: Economic and Accounting
Implications

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Goodwill: definition and measurement

• Goodwill represents
  – synergies and superior earnings power

• Accounting for goodwill
  – initially recognized as the excess of purchase price over fair value of net assets acquired
  – consists of pre-merger synergies and post-merger synergies (SFAS 141)
  – reported as long-lived assets
  – subsequent reporting: amortization → write-off.
The rise of goodwill: 1990 to 2009

Year

% of firms with goodwill

Goodwill / Total assets
Accounting research on goodwill

• Mechanic amortization of goodwill is not value relevant

• Not much is known about
  – economic determinants of goodwill
  – relation between goodwill and future performance
  – implications for subsequent goodwill write-off.
What drives acquisition?

• Earlier views
  – exploitation of synergies and efficiency gains
  – lack of empirical support

• Valuation-based explanation
  – acquisition is an efficient way for rational managers to exploit market mispricing (Shleifer and Vishny, 2003) → overvalued firms tend to acquire more
  – similar views from subsequent research (e.g., Rhodes-Kropf et al., 2005).
Acquisition with overpriced shares

• There are net gains from acquisition with overpriced shares (Shleifer and Vishny, 2003)
• Managers are “hubris” when using overpriced shares to acquire others (Roll, 1986)
• Managers often make ill-advised acquisitions when acquisitions are made to justify overvaluation (Stein, 1996).
Is goodwill good?

• Circumstances of acquisition are relevant for assessing the value of goodwill
  – acquisition price and its determinants (e.g., relative bargaining power of bidder vs. target)
  – fair value of acquired assets
  – relative valuation of acquirer and target
• Bidder/target overvaluation ≠ extent of goodwill
• Goodwill write-off is a useful test
  – but it is only done ex post.
What about goodwill write-off?

• Prevalent and large
  – from 2003 to 2009, more than 4,600 firms have written-off goodwill due to impairment, including 1,393 firms in 2008
  – amount of goodwill write-off totaled $970 billion, representing 20% of recorded goodwill

• The news of goodwill write-off also precede CEO resignation and can trigger shareholder lawsuit.
What about goodwill write-off?

• According to managers
  – goodwill write-offs are the natural result of acquisition with overpriced shares → it is just a benign, inconsequential accounting ritual with no real substance (e.g., no effect on cash flows)
  – write-offs reflect the effects of economic recession, industry downturn, etc → no necessary relation with prior acquisition decisions

• Our research suggests different implications.
Example of events: eBay’s acquisition of Skype

- Acquired Skype

- Wrote off goodwill ($1.43b)
Gu and Lev (2010)

• We examine the root cause of goodwill write-off by tracing goodwill write-offs back to prior acquisitions giving rise to goodwill

• Focus on share overvaluation prior to acquisition as an antecedent of goodwill write-off
  – the relation is empirical in nature
  – overpriced shares → ill-advised acquisition → lack of synergies → goodwill impairment.
Main findings

• The extent of share overpricing is positively associated with the incidence of acquisitions, particularly stock-financed deals, and, more importantly, the magnitude of goodwill

• This relation is strengthened by managerial share holding and weakened by good corporate governance

• The effect is stronger for foreign acquisitions.
Main findings (cont.)

• Share overpricing has a positive relation with subsequent goodwill write-offs and shareholder lawsuits alleging ill-advised acquisitions.

• Acquisition with overpriced shares and the extent of goodwill have negative effects on future stock performance and accounting profitability beyond the reversal of share overpricing.
Main findings (cont.)

• The extent of share overpricing predicts the occurrence and magnitude of subsequent goodwill write-off and the incidence of shareholder lawsuits involving ill-advised acquisitions

• Firms with goodwill write-offs significantly under-perform in future.
Implications of goodwill write-off

• Key issue
  – acquisition price vs. post-merger synergies
• Our results suggest that share overpricing lead to ill-advised acquisitions with negative consequences
• Accounting test for goodwill impairment may conceal ill-advised acquisitions because
  – test is performed at operating unit level
  – allows capitalization of intangibles in the test.