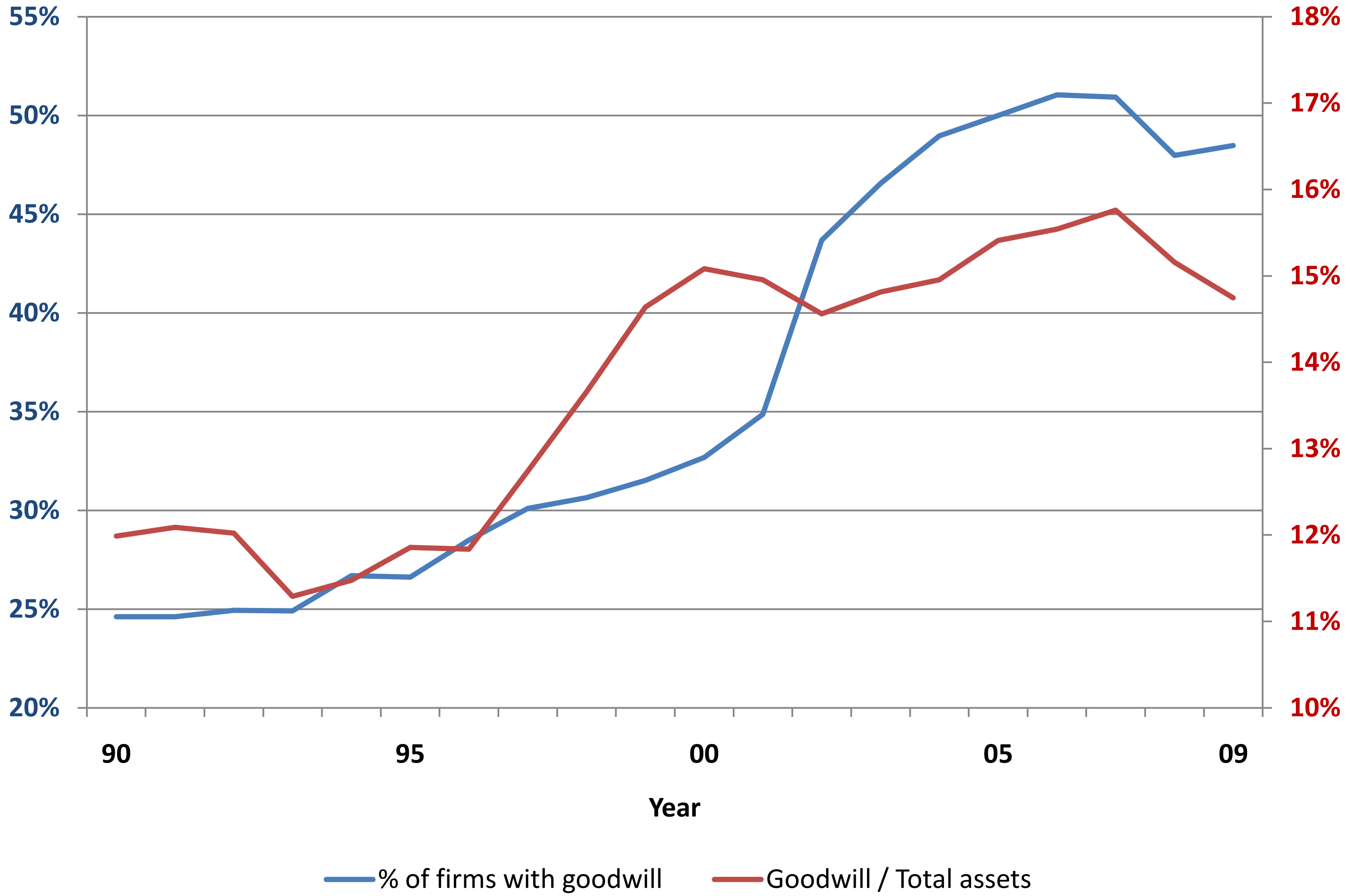
Goodwill and Goodwill Write-off: Economic and Accounting Implications

Feng Gu
SUNY at Buffalo

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



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.

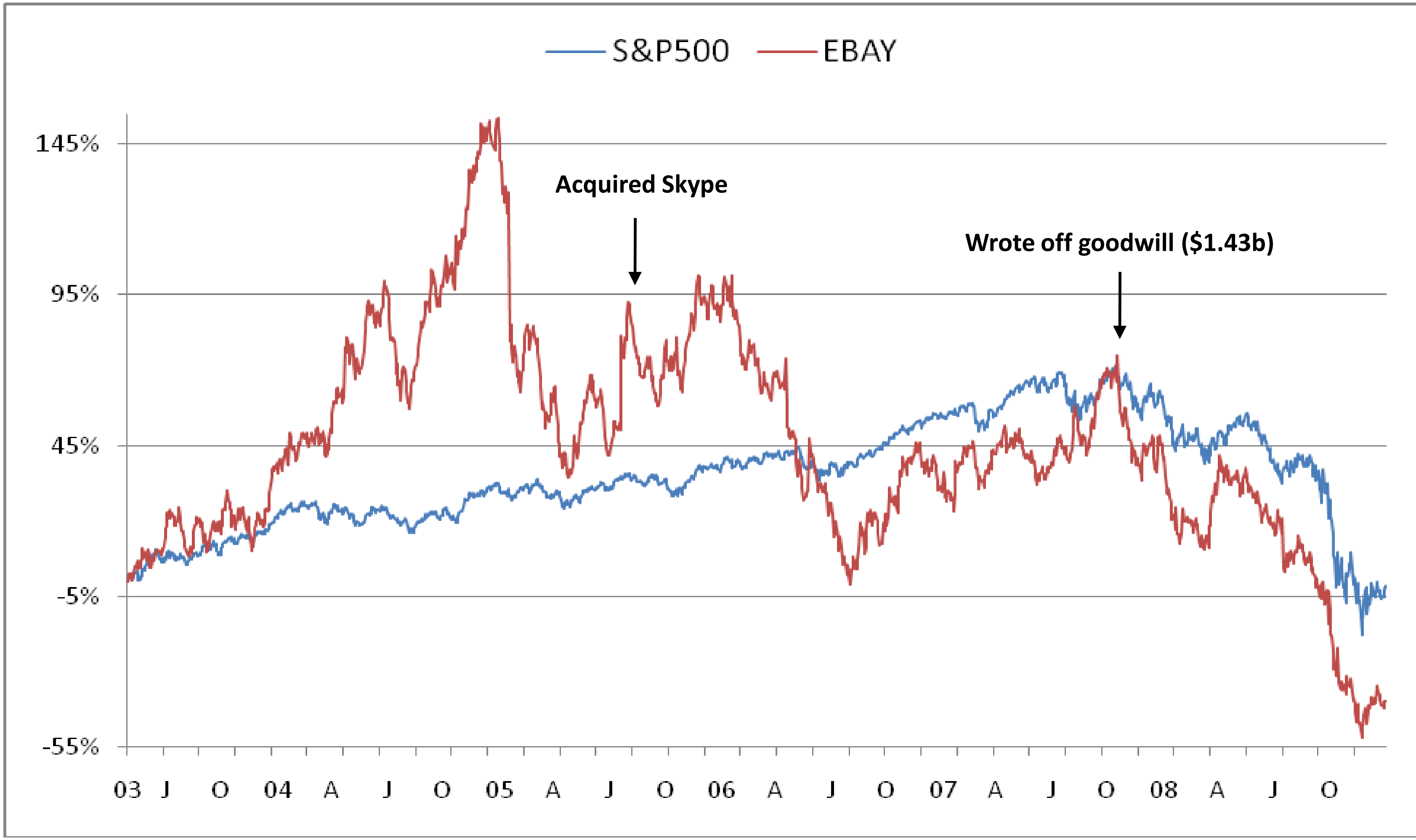
What about goodwill write-off?

- 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



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.