THE IMPACT OF MERGERS AND ACQUISITIONS ON EARNINGS PREDICTABILITY

Grigori Erenburg, George L. Argyros School of Business and Economics (ASBE), Chapman University, One University Drive, Orange, CA 92866, (714) 628-7372, erenburg@chapman.edu

Praveen Sinha, George L. Argyros School of Business and Economics (ASBE), Chapman University, One University Drive, Orange, CA 92866, (714) 744-7986, sinha@chapman.edu

ABSTRACT

This paper examines the impact of corporate acquisitions on the firms' earnings predictability as evidenced by the properties of the forecasts issued by the analysts before and after the event. The ability to accurately forecast earnings is important for estimating the value of a firm in an acquisition transaction. If the ability to forecast earnings deteriorates then this cost should be accounted for in evaluating the decision. On the other hand, if the ability to forecast earnings improves, then this benefit should also be included when analyzing the acquisition decision. The limited evidence in the literature points to significant deterioration in earnings predictability after acquisitions.

We argue that the predictability of earnings after corporate acquisitions is a function of change in (a) forecasting task complexity and (b) analyst following, after appropriate controls. Acquisition of a firm from a different industry (inter-industry acquisitions) tends to increase task complexity and information asymmetry and should make post-acquisition earnings less predictable. Whereas acquisitions of firms from the same industry (intra-industry acquisitions) tend to increase the firm size within its industry and should result in increased analyst following and reduced information asymmetry, resulting in more predictable earnings.

We construct a sample of approximately 400 acquisitions of 1995-2004. Contrary to the finding of earlier studies, we find that the accuracy of analysts' consensus forecast does not always deteriorate. In acquisitions involving firms within the same industry that are accompanied by increase in analyst following, the forecast accuracy does not change. In other acquisitions, the forecast accuracy does deteriorate. Specifically, we find that, one year after the acquisition, there are no significant differences in forecast errors of the firm from its pre-acquisition levels in case of intra-industry acquisitions. In case of inter-industry acquisitions the errors are significantly higher even one year after the acquisition. These results are consistent with the evidence from the analysts' forecast literature on equity carve-outs. The intra/inter industry nature of the acquisition seems to be the key to evaluating the future costs associated with the merger.

This study has implications for future research as it provides alternate ways to partition the acquisition transactions. This alternate partition, based on the acquisition of likes accompanied with increased analyst following, has not been examined in earlier studies.