Asset Writedowns: Managerial Incentives and Security Returns: Discussion

Author(s): Anjan V. Thakor

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DISCUSSION

ANJAN V. THAKOR*: This paper takes a close empirical look at asset writedowns by firms. An asset writedown is simply a downward revision in the value of an asset as it is recorded on the books. Thus, the rich history of market efficiency studies would seem to suggest that, on an *a priori* basis, we should not expect any significant market price reaction to this bookkeeping adjustment. What is (mildly) surprising then is that the empirical analysis in this paper reveals a price reaction. The principal finding is that there is a statistically insignificant average cumulative abnormal return (CAR) prior to the announcement of a writedown, and a statistically significant, positive average CAR after the announcement (Table 7). This is an interesting finding. Moreover, the empirical analysis seems to be carefully done.

The remainder of this discussion revolves mainly around three issues. First, how should we interpret the findings of this study? This is particularly important since the paper—while doing a careful job of analyzing the data—does not offer sufficient help in putting the results in a useful overall perspective. Second, I will have something to say about further analysis that could shed more light on the issues explored here. And finally, I will comment briefly on the exposition and the overall approach in the paper.

It appears that the authors interpret their findings as evidence indicative of the failure of semi-strong form market efficiency. This interpretation is apparent

* Indiana University.

in many places in the paper. It is often argued that poorly performing firms may wish to avoid asset writedowns because they may be reluctant to further reduce an equity base that has already been depleted by operating losses. This seems to suggest that the market is somehow "fooled" into thinking that the book value of a given asset is its true economic value and will, therefore, react negatively to a move that reduces book value. I think that this interpretation is misleading. I see little evidence of market inefficiency in this paper. I believe that the authors' findings support the conjecture that writedowns have a price effect *not* because they mean much by themselves but because they are a *signal* of events to come. In this respect, writedowns are similar to *stock splits*. A stock split means little by itself. Yet empiricists have discovered significant announcement effects. Closer scrutiny has revealed that firms that split stocks also do very well in the post-split period. Thus, a split is a signal to the uninformed that high cash flows are expected in the future by *insiders*. In like vein, I conjecture that asset writedowns are a signal of economic value-enhancing *corporate restructuring* to come in the future. In fact, there is ample *preliminary* evidence in the paper to support this conjecture. Consider the following: (i) The authors had to reduce their sample size from 120 to 78—a reduction of over 36%—to eliminate firms that had restructured, including changes in dividend policy and stock repurchases. This suggests a strong contemporaneous correlation between asset writedowns and corporate restructuring. It is also suggestive of a belief in the market that major corporate restructuring is likely to be *preceded* by less drastic action in the form of asset writedowns. (ii) Asset writedowns are found to be closely associated with the replacement of senior management by outside managers. Since corporate restructuring is much more likely following a changing of the guard, the asset writedown subsequent to a management change may be a confirmation of new management's resolve to implement more sweeping changes. (iii) The only statistically significant market reaction comes immediately *after* the announcement of the writedown. This indicates that the market waits to see if the proposed writedown is likely to lead to a restructuring or if it is just an inconsequential accounting manipulation. (iv) The larger the asset writedown (relative to book equity), the greater is the excess return around the announcement period. This is familiar from signaling models—the stronger the signal, the greater is the price response.

Next, I take up the question of what a sequel to this paper should do. In view of the preceding discussion, I believe that a *direct* test of the signaling hypothesis would be very useful. Following the lead of the stock split studies, there should be an analysis of the link between the post-writedown announcement excess return and the extent of corporate restructuring. This would enable an examination of the extent to which the market's expectations about restructuring, that were formed on the basis of the preceding writedown, were actually realized. In fact, this might have been a useful extension to include in the present study.

With respect to the exposition in this paper, I think the authors could have done greater justice to their analysis if they had adopted a different approach to the exposition. A weakness of the paper is that the authors are not sufficiently convincing about why we should suspect that an asset writedown has a statistically significant price impact. What follows then seems like a lot of hard work to detect empirical regularities that *may* have no reason to exist. Thus, the paper suffers from the lack of an economically appealing (refutable) hypothesis that is discussed prior to the tests. What makes this somewhat surprising is that there *does* seem to be a plausible story about price effects—leading to a testable hypothesis— with which one can start.

I would also suggest that the authors take a close look at the 42 firms that they discarded because of contemporaneous contaminating events such as dividends and stock repurchases. Recent papers on multi-dimensional signaling models have led to testable predictions about price effects related to two (or more) simultaneous signals (see, for instance, Ofer and Thakor (1987)). Moreover, it should also be recognized that the standard event study methodology is not without its weaknesses. A more discriminating econometric approach, which provides a better measure of abnormal return, is developed in Acharya (1987).

In closing, I view this paper more as a promising start than as a finished product. The authors have brought to light some interesting regularities that deserve further empirical scrutiny. Hopefully, some theorist will even extract sufficiently appealing stylized facts from those efforts to be inspired to give us a theory.

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