Advances in Accounting 37 (2017) 71–84

Contents lists available at ScienceDirect

Advances in Accounting

journal homepage: www.elsevier.com/locate/adiac

Refocusing through discontinued operations in response to acquisitions and diversification

Richard A. Lord[a], Yoshie Saito[b,*]

[a] Department of Accounting & Finance, Feliciano School of Business, Montclair State University, Upper Montclair, NJ 07043, United States
[b] School of Accountancy, Strome College of Business, Old Dominion University, Norfolk, VA 23529, United States

ARTICLE INFO

JEL classification:
G34
M44
M48

Keywords:
Discontinued operations
Acquisitions
Corporate focus

ABSTRACT

We examine how prior acquisitions and the extent of corporate diversification affect decisions to discontinue operations. These choices comprise a very important class of publicly announced disposal decisions, and analyzing them allows us to utilize a much larger sample than most prior studies of divestitures. We employ a multinomial logistic regression setting to test our three hypotheses; this framework allows us to assess the difference in choices regarding positive- and negative-valued announcements of discontinued operations. We find that firms are less liable to report negative-valued divestitures in the year of an acquisition, and are more likely to discontinue operations, especially with negative values, two and three years after. The effects of the size of an acquisition on disposal decisions differ sharply between large and small firms. The magnitude of an acquisition has little influence on subsequent divestiture choices by smaller enterprises. However, large companies are more likely to make positive-valued discontinuations in the year of and year following a major acquisition, which is consistent with the view that valuable but unwanted units are often shed soon after large complex acquisitions. We find strong support for the Corporate Focus Hypothesis, positing that highly diverse firms are more likely to divest assets. We also show that when a company announces its first discontinued operation, this normally follows a period of increasing corporate diversification, and the majority of subsequent disposals take place as intermediate steps in a down-sizing process.

1. Introduction

Dranikoff, Koller, and Schneider (2002) and Brauer (2006) note that divestures are among the most important business decisions; however, they have received far less attention in the literature than acquisitions. We aim to contribute to the understanding of why, when and how managers choose to divest. While most prior empirical studies are based on small samples because they rely on public announcements of asset sales, which are rare, we focus on discontinued operations, which provide a much larger sample and represent clearly identifiable strategic choices, encompassing various kinds of disposal decisions. These occurrences are also particularly interesting as they can take either positive or negative values, which reveal some information on whether the disposal is a strongly or poorly performing unit.

We examine three aspects of divestiture decision-making. First, we provide a detailed analysis of the interrelationship between acquisitions and subsequent announcements of discontinued operations. Second, we ask whether the extent of corporate diversification drives the choice to downsize. This question is directly related to the focus hypothesis, which posits that a major reason for firms to divest operations is overly-wide corporate diversification. Third, we examine whether announcements of discontinued operations represent the beginning of a process of sharpening corporate focus, or the culmination of actions leading to less diversified and more manageable operations. We employ a series of multinomial logistic regression models to test our hypotheses. The dependent variable is arranged into three discrete classes so that we may assess differences between firms that announce positive- or negative-valued discontinued operations.

Porter (1987) and Ravenscraft and Scherer (1987) show that corporate acquisitions are often followed by divestitures. There has been a good deal of research indicating that the disposal of these assets is the result of misguided investments (Bergh, 1997; Capron, Mitchell, & Swaminathan, 2001; Hoskisson, Johnson, & Moesel, 1994; Kaplan & Weisbach, 1992; Kruse, 2002). In contrast, Weston (1989) and Bergh (1997) note that a significant number of divestitures feature the disposal of valuable but unwanted operating units following a large acquisition. Hamilton and Chow (1993) and Dranikoff et al. (2002) note that most managers view disposals as important strategic choices about

* Corresponding author.
E-mail addresses: lordr@mail.montclair.edu (R.A. Lord), ylord@odu.edu (Y. Saito).

http://dx.doi.org/10.1016/j.adiac.2017.04.001
Received 8 February 2016; Received in revised form 28 March 2017; Accepted 3 April 2017
Available online 17 April 2017
0882-6110/ Published by Elsevier Ltd.

the optimal use of resources. The complexity of the interrelationship between acquisitions and divestitures is underscored by anecdotal evidence from recent choices by Motorola, Google and Lenovo. They represent the sale of an unwanted but valuable unit soon after an acquisition, for a gain, and the subsequent divestiture of another unit for a loss after it was deemed unsuccessful.

In January 2011, Motorola spun-off its mobile device and set-top box division as Motorola Mobility. In August of the same year, Google purchased the new entity for $12.5 billion. Google's main interest was to acquire Motorola Mobility's portfolio of patents, which were related to Android devices. Google was not interested in the set-top box operation, and so quickly arranged to sell that division to Arris Group for $2.35 billion (Savitz, 2012). The total reported value of discontinued operations from the gain on the sale of the unit was $757 million. Within one year, Google sold the mobile phone assets to Lenovo after disappointing sales of the Motorola Moto X-Phone, but retained the vast bulk of the patents (Miller & Gelles, 2014). This example clearly demonstrates that acquisitions and disposals often go hand-in-hand, which motivates our investigation of whether divestitures tend to follow acquisitions.

There is earlier empirical evidence that disposal decisions are often the result of earlier over-diversification. As a firm's operations become more diverse, it can be progressively more difficult for the management team to oversee the disparate units. Inefficient and nonproductive segments can also siphon resources away from profitable or strategically important core assets. In early work on the subject, Comment and Jarrell (1995) and John and Ofek (1995) find that widely diversified firms, tend to perform poorly and are more likely to divest operations. Daley, Mehrotra, and Sivakumar (1997) dub this proposition the Corporate Focus Hypothesis. Therefore, our second question is whether the extent of corporate diversification drives the choice to downsize through discontinued operations.

Our third question concerns management's response to the recognition that diversification has become untenable. In some cases, a divestiture might be the first sign of such realization or, if corporate focus were already narrowing, the action might be one in a chain. While firms may engage in gradual restructuring activities to improve performance (Atiase, Platt, & Tse, 2004), discontinuing an operating unit requires a more substantial and unwavering commitment to a strategy. Once a unit is sold or abandoned, it is much more difficult to rebuild an operation. We examine how recent changes in diversification may affect managers' decisions to discontinue operations.

With regard to our first hypothesis, concerning the interrelationship between acquisitions and subsequent announcements of discontinued operations, we find that, in the year of an acquisition, companies are generally less likely to discontinue negative-valued operations. Firms that make large acquisitions are more liable to announce positive-valued discontinued operations in that same year. However, both positive and negative-valued divestitures are most common two or three years following an acquisition.

There are interesting differences between large and small companies. For small firms, the size of an acquisition has little effect on contemporaneous or subsequent divestitures, while large entities are far more likely to divest positive-valued operations in the years of and after an acquisition. Larger firms are also less prone to dispose of negative-valued assets two or three years after an acquisition. Overall, our findings support the proposition of Weston (1989) and Bergh (1997) that firms quickly divest unwanted divisions in acquisitions of large complex organizations, and later dispose of acquired assets that they have come to view as unsuccessful investments. This is also consistent with the anecdotal evidence from Google's sequence of divestitures of the assets of Motorola Mobility.

We find that more widely diversified organizations are far more likely to discontinue operations. This supports the Corporate Focus Hypothesis that decreasing company diversification is a powerful motivation to dispose of ancillary units. We also find that firms with high leverage, low profitability and Tobin's Q, and that are in danger of bankruptcy are more likely to engage in discontinued operations. In addition, smaller firms are more likely to dispose of operations. Collectively, these results suggest that when the extent of diversification becomes unmanageable or firms cannot exploit the economies of scale of diversification, managers tend to divest marginal assets to focus on core operations.

For our third hypothesis, we examine the relationship between recent changes in corporate focus and decisions to discontinue operations. There is clear evidence that firms are more likely to divest an operation if they have altered their strategic focus within the previous three-year period. Our base model shows that firms that discontinue operations are more likely to have been sharpening their corporate focus in the recent past. However, when we examine a smaller sample of companies, that have made only a single divestiture, we find that a greater proportion of these have expanded diversification in the previous three years. The findings suggest that a first divestiture is generally a response to perceived over-diversification, while subsequent disposals represent continued progress toward a more optimal corporate structure.

We contribute to the prior literature in the following ways. First, earlier research on the focus hypothesis uses small samples based on publicly announced asset sales (Comment & Jarrell, 1995; John & Ofek, 1995). We show that reports of discontinued operations are associated with more general corporate focus decisions. This is an important extension of the prior literature because the broader category will allow future researchers to collect much larger samples to conduct empirical analyses of managers' down-sizing decisions.

Second, we provide empirical evidence on the relationship between acquisitions and disposal decisions that helps to clarify some of the motives for positive-valued divestitures (Kaplan & Weisbach, 1992; Mulherin & Boone, 2000; Porter, 1987; Ravenscraft & Scherer, 1987). Our findings show that (a) positive-valued disposals often follow acquisitions, because acquirers are often seeking very specific technologies, and that (b) large firms are more likely to report positive-valued disposals immediately following major acquisitions.

Third, we are the first to show that the typical announcement of a discontinued operation occurs in the middle of the restructuring process. Entities that engage in discontinued operations have often decreased their diversification in recent years. However, firms that report discontinued operations for the first time generally have been increasing diversification in the recent past. This seems to suggest that there may be an optimal level of complexity and scope of operations that managers are seeking to achieve and maintain. We believe our study is the first to document this type of ongoing quest for the correct level of diversification.

Lastly, our evidence clearly indicates that information contained in discontinued operations captures important changes in corporate strategy, such as increased focus on core operations, and the acquisition or abandonment of specific technologies. This supports the contentions of Dranikoff et al. (2002) and Brauer (2006), and provides a managerial decision perspective to existing accounting research on discontinued operations that focuses more on reporting mechanisms (Barua, Lin, & Sbnaraglia, 2010; Curtis, McVay, & Wolfe, 2014).

The remainder of the paper is arranged as follows. In the next section, we provide some background information on discontinued operations. Then, we examine the historical relationship between acquisitions and discontinued operations using aggregate data, discuss the background literature and develop our hypotheses. In the fifth section, we define our explanatory variables, and then describe the data and present univariate statistics. In the seventh section, we describe our multinomial logistic regression specification, and discuss the parameter estimates and some sensitivity analyses to test the robustness of our results. Finally, we conclude and summarize our findings.