DOES GOODWILL IMPROVE FIRM PERFORMANCE? EVIDENCE FROM THE MENA REGION

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Abstract

As one of the main components of intangible assets appearing in the balance sheet, Goodwill has long been considered a as a driver of sustainable competitive business and corporate advantages. Yet, does goodwill really improve performance of firms in the MENA region? This paper documents the effect of goodwill on firm performance during the period between 2005 and 2015. The results of our analysis show that high level of goodwill has a positive impact on firm performance in large firms. Yet, at small firms, goodwill was not proved to improve performance. This can be explained by the fact that only good performing firms invest in goodwill while smaller firms simply struggle to generate tangible assets.

Keywords: Goodwill, Corporate Reputation, Firm Performance, Emerging Markets

1. INTRODUCTION

Researchers and practitioners have reached a general consensus that intangible assets play a vital role in the success and survival of firms in today's economy. In recent decades, focus has shifted from the traditional financial statements that focus on tangible assets into intangible assets like innovation, knowledge, intellectual property, and goodwill. In the United Kingdom, businesses in 2011 had a £137.5 billion investment in intangible assets (Goodridge et al., 2014).

Actually, there is no universally accepted definition of intangible assets. Still, there is a number of characteristics that most definitions have in common. Intangible assets are non-physical, potential sources of future economic gain. These sources are generally retainable and tradable. They include Research and Development, patents, trademarks, human resources and capabilities, organization competencies, relational" capital (customer and supplier networks, organizational design and process), and corporate reputation (sometimes referred to as goodwill) (OECD 2006)[6]. Another characteristic that differentiates intangibles from other assets is that most of them are not traded in an active and transparent market. When goodwill is traded for example, detailed information are usually not available to the public.

Several studies proved that intangible assets have a positive impact on firm performance and value. Rodov & Leliaert (2002) confirm these findings and explains this value gap by the fact that the assets reflected in companies financial statements are calculated less than the actual value of the company. These results were strengthened by Satt (2016), as cited by Gamayuni (2015), who proved, in his study of 3500 companies in the United States, that the current book value was only 28% of market value (in 1975 still 95%), and in the last 20 years there is a dramatic increase in the value of intangible assets. The significant gap between the book value of equity and the equity markets value, and the high intangible assets in recent years incited researchers to prove whether the intangible asset is a significant factor in increasing the value and performance of the company. Gamayuni (2015) provides empirical evidence that intangible assets have positive and significant influence on financial performance (ROA) and firm value.

Goodwill, sometimes referred to as corporate reputation, is one of the main components of intangible assets appearing in the balance sheet. For many years, the view that corporate reputation positively impacts firm performance has been documented. Reputation is an intangible asset increasingly seen as a driver of sustainable

[6] OECD, 2006.The Knowledge-based economy, OECD/GD (96)102

competitive business and corporate advantages (Roberts & Dowling, 2002; Mishra & Suar, 2010; Neville et al., 2005; Eberl & Schwaiger, 2005). Goodwill is the reputation an organization enjoys based on the publics of that organization derived from information about the organization's relative position to other organizations in the industry. It can also arise out of consumers' experience with the company's products. Therefore, the value of goodwill can be inherited from an organization's past strategies.

2. LITERATURE REVIEW

Prior literature establishes a positive relationship between firm corporate reputation (goodwill) and its financial and equity market performance (Bennett & Kottasz, 2000; Helm, 2007; Bontis et al., 2000). Chung et al. (1999) focus on how a company's reputation influences the value of its stocks in the stock market. They found that firms with highly ranked corporate reputation outperform, on a total equity return basis, firms with lower reputation.

Again, Brammer & Pavelin (2004) demonstrate that investors make abnormal returns when purchasing stocks of firms whose reputation has risen significantly. Other studies suggest that a good corporate reputation lead companies to increase the prices of their products/services (Iwu-Egwuonwu, 2011). That is, organizations that have higher reputation put higher price tags on their products than would lower reputed organizations. This suggests that reputation or goodwill works as a signal for quality. In another study that analyzes how corporate reputation affect the pricing power in electronic markets. Ghose & Yang (2009) demonstrate that reputation not only helps corporate performance but also that a negative reputation hurts more than a positive one helps. The authors demonstrate that good corporate reputation substantially improves firm performance.

Goodwill is increasingly researched as sources of sustainable advantages. Researchers, consultants and practitioners are now active in the development of tools to measure the intangible brand equity such goodwill (reputation). Reputation may be seen as an output of different activities in the professions (Schwaiger, 2004). Though reputation is an intangible concept, a good reputation demonstrably increases corporate worth and provides sustained competitive advantage (Karim, 2006).

Tan (2007) affirms the empirical evidence that corporate reputation is positively correlated with superior earnings quality. He demonstrates that corporate reputation not only leads to superior earnings quality but also helps in producing superior total sales in Chinese public companies.

In this work, we tend to extend the above strand of literature by documenting whether the value of goodwill (corporate reputation) improves firm performance. Schwaiger (2004) notes that reputation is seen, in accounting, as a kind of goodwill. In this study, we measure corporate reputation by goodwill since it is measurable with a numeric value in the balance sheet. Goodwill is also used for other reasons as explained later in the following section.

Our study will be performed at a large scale, including listed companies from the MENA region. To the best of our knowledge, this is the first attempt to relate goodwill to firm performance in Morocco and the MENA region.

The remainder of the paper is organised as follows. Section 2 provides the theoretical framework and hypothesis development. Section 3 summarizes the data. Section 4 presents and discusses the empirical findings. Section 5 discusses implications of our findings and Section 6 concludes.

In our research paper, we tend to examine whether the value of goodwill (corporate reputation) improves firm performance. We focus on goodwill as a measure of corporate governance for many reasons. First, goodwill represents a significant amount on a company's balance sheet transmitting present and forward looking information relevant to a firm. Second, preceding literature suggests that goodwill data provide a useful perspective on the hard-to-measure going concern (reputational) value component of firm economic value (Chauvin & Hirschey 1993). Third, the goodwill has been shown to have information content and recognized goodwill to be value relevant (Al Jifri & Citron 2009). Finally, goodwill losses are considered as a leading indicator of a decline in future profitability (Bens et al. 2011; Satt 2015).

To test the findings of the literature above, we examine in this work whether the value of goodwill, as a measure of corporate reputation, positively affects firm performance. Hence, we test the following hypothesis:

H1: There is a positive relationship between goodwill and firm performance

3. DATA

3.1. Goodwill

This paper examines whether goodwill positively affect firm performance in the MENA region. We select Morocco, Jordan, Bahrain, Egypt, Kuwait, United Arab of Emirates, Saudi Arabia, and Qatar. We define goodwill by the value appearing in the balance of firms in the sample. The sample period is from 2005 to 2015. Panel A document descriptive statistics for each year, while Panel B and Panel C document similar statistics for each country and each industry respectively.

Panel A presents descriptive statistics for each year, while Panel B and Panel C presents similar statistics for each country and each industry respectively. Our results in Table 1, Panel A, show that goodwill gradually increased from 0.1998 in 2005 to 2.0981 in 2015. It shows gradual improvement in the value of goodwill in the MENA region. Furthermore, Table 1, Panel B, shows that firms headquartered in Qatar, Saudi Arabia, and United Arab Emirates have the highest level of goodwill in the region. We report average goodwill value of 2.9871 Qatar, 2.0987 in Saudi Arabia, and 3.7612 in United Arab Emirates. Table 1, Panel B, also reports that firms in Bahrain and Egypt have the lowest levels of goodwill in the region. The results in Table 1, Panel C, show that firms belonging to Telecommunication sector have the highest level of goodwill. It is intuitive because most of Telecommunication firms are large and very profitable firms in the region.

Table 1. Descriptive statistics for Goodwill

The following table documents the descriptive statistics for Goodwill in the MENA region, i.e. Morocco, Jordan, Bahrain, Egypt, Kuwait, United Arab of Emirates, Saudi Arabia, and Qatar. The sample period is from 2005 to 2015. Panel A document descriptive statistics for each year, while Panel B and Panel C document similar statistics for each country and each industry respectively.

Panel A: Levels of Goodwill in different years

Years	Average	Standard Deviation
2005	0.1998	0.8497
2006	0.2998	1.0966
2007	0.4911	1.1211
2008	1.0439	2.1206
2009	1.3901	2.6122
2010	1.2245	2.9981
2011	1.2899	3.1122
2012	1.8661	2.3321
2013	1.8801	3.0012
2014	1.9088	3.0998
2015	2.0981	3.1123

Panel B: Levels ofGoodwill in different countries

Countries	Average	Standard Deviation
Bahrain	0.4887	0.2230
Egypt	0.7871	1.2334
Jordan	0.8763	0.9272
Kuwait	1.9873	1.9951
Morocco	1.8977	1.2872
Qatar	2.9871	1.1100
Saudi Arabia	2.0987	0.2332
United Arab of Emirates	3.7612	2.9881

Panel C: Levels of Goodwill in different industries

Industry	Average	Standard Deviation
Oil and Gas	0.1651	0.9318
Basic Materials	0.9000	1.5111
Industrials	0.1810	1.6066
Consumer Goods	0.5601	0.9353
Healthcare	0.6000	0.8139
Consumer Services	0.5350	1.5351
Telecommunication	5.1600	5.6119
Utilities	1.6385	1.1816
Financials	0.1851	1.9611
Technology	1.1538	3.1904

3.2. Firm Performance

This paper measures firm performance by market-adjusted returns (RET). We define RET as the difference between stock returns and market returns. Stock prices and market index are obtained from the Datastream. The stock price data and the market index data was obtained for the first and the last day of a given year to compute RET.

3.3. Control Variables

This paper uses the following firm-specific characteristics as control variables. The data for control variables is obtained from the Worldscope.

- **EVA**: The economic value added (EVA) measures the firm's performance from an accounting perspestive. Data of the sample are obtained from the Datastream.

EVA is the surplus left after making an appropriate charge for the capital employed in the business. It was calculated in the following way.

EVA = NOPAT – (TCE x WACC)

Where:

NOPAT = Net operating profit after tax
TCE = Total capital employed
WACC= Weighted average cost of capital

Actually, many organizations use profit-based measures as the primary measure of their financial performance. This measure might raise two main problems related to profit (Sharma & Kumar, 2011). First, profit ignores the cost of equity capital. Companies only generate wealth when they generate a return in excess of the return required by

providers of capital (equity and debt). Accountants take into account the cost of debt, but ignore the cost of equity. Second, Profits calculated in accordance with accounting standards do not truly reflect the wealth that has been created, and are subject to manipulation by accountants. The Economic Value Added is a performance measurement system that aims to overcome these weaknesses. The use of the EVA as a controlling variable of firm performance has also been supported by many other studies. Lovata & Costigan (2002) demonstrate that the EVA helps in reducing Agency conflict and improve decision making. Maditinos et al. (2006) convey that EVA is more strongly associated with stock return than other measures. Finally, Erasmus (2008) demonstrates that EVA adds more informational content in explaining stock returns.

- **SIZE:** We measure size by log of market capitalization. Literature suggests that large firms have lower agency problems due to increased interest from stock market participants. Lower agency problems should lead to better performance of large firms (Fang et al., 2009). Additionally, Bhattacharyya and Saxena (2009) demonstrate that larger firms have better bargaining power over their suppliers and competitors, which leads to a better performance.
- **LEVERAGE:** We measure leverage by total debt to total asset ratio. High leverage exposes firms to greater financial risk and therefore to lower performance (Mitton, 2002).
- **GROWTH:** This paper measures GROWTH by growth in earnings per share. Jegadeesh and Livnat (2006) argue that firms with higher growth have better performance.
- **PoR:** It is defined as percentage of earnings paid as dividends. Prior literature shows that dividends are considered as a tool to reduce information asymmetries (Jensen, 1976; La Porta et al., 2000).
- **VOLATILITY:** It is the measure of a stock's average annual price movement to a high and low from a mean price for each year. We expect firms with high volatility to exhibit low stock price performance.

Table 2 documents the statistics for our control variables during our sample period. Panel A documents the descriptive statistics for control variables used in our analysis and Panel B documents the correlation between different control variables. As is expected, Table 2, Panel A, shows that firms in the MENA region pay low fraction of their earnings as dividends. Our results show that the PoR is 40.4313 % for our sample firms compared to 80% in developed countries. Table 2, Panel A, also shows that firms in the MENA region have very low leverage. This observation is consistent with prior literature that shows that firms in the MENA region rely on their retained earnings for their long-term financial needs (Achy, 2009). Furthermore, Table 2, Panel B, shows low correlation between our control variables, which allow us to include these variables in our regression analysis.

Table 2. Statistics for control variables

The following table documents the statistics for control variables used in regression. The sample comprise of firms from Morocco, Jordan, Bahrain, Egypt, Kuwait, United Arab of Emirates, Saudi Arabia, and Qatar. The period of analysis is from 2005 to 2015. Panel A document descriptive statistics for control variables, while Panel B document correlation between different control variables.

Panel A: Descriptive statistics for standardized Mean, Median and Standard deviation

	Mean	Median	Standard Deviation
EVA	3.2105	0.1344	13.3025
SIZE	3.4643	9.4533	4.4454
LEVERAGE	14.3542	14.3342	14.3584
VOLATILITY	20.3121	45.5361	11.7444
PoR	40.4313	31.1022	45.2361
GROWTH	10.1245	4.7141	55.2347

Panel B: Correlation matrix

	EVA	SIZE	LEVERAGE	VOLATILITY	PoR	GROWTH
EVA	1.0000					
SIZE	0.4445	1.0000				
LEVERAGE	-0.0443	-0.0063	1.0000			
VOLATILITY	-0.3254	0.4442	0.0345	1.0000		
PoR	0.3426	0.0214	-0.0706	-0.3612	1.0000	
GROWTH	-0.0340	-0.0432	0.0074	-0.0643	-0.3240	1.0000

4. METHODOLOGY

This paper aims to document the effect of goodwill on firm performance in the MENA region. In order to test this hypothesis, we estimate a regression equation with market-adjusted returns (RET) as a dependent variable and two variables representing goodwill (GOODWILL) and square of goodwill (GOODWILL * GOODWILL) as independent variables. Goodwill was squared after performing "RAMSEY RESET" Test in order to make sure that the relationship between Goodwill and performance is a linear one. Furthermore, as mentioned above, we include a number of control variables in our regression equation. These variables are Economic Added value (EVA), log of market capitalization

(SIZE), total debt to total asset ratio (LEVERAGE), stock price volatility (VOLATILITY), dividend payout ratio (PoR), growth in earnings per share (GROWTH), and year dummies (YDUM). Our basic regression takes the following form. We need to mention here that we used panel data regression with fixed effects for our analysis. We used Hausman test to distinguish between fixed effect and random effects.

$$\begin{aligned} RET = {} & \alpha + \beta_1(GOODWILL) + \beta_2(GOODWILL*GOODWILL) \\ & + \beta_3(EVA) + \beta_4(SIZE) + \beta_5(LEVERAGE) + \beta_6(VOLATILITY) \\ & + \beta_7(PoR) + \beta_8(GROWTH) + \sum_{Yr} \beta^{Yr}(YDUM) + \varepsilon \end{aligned} \quad (1)$$

The results of our analysis are reported in Table 3. Our results show that goodwill improves firm performance only at high levels. We report significant and positive coefficient of GOODWILL*GOODWILL. However, for GOODWILL, the coefficient was surprisingly negative and significant, which was against our expectations. As expected, the EVA, which was used as an accounting firm performance measure, had a positive and significant coefficient, as expected. VOLATILITY, Por, and GROWTH had average significance; given an R^2 of 52%.

Table 3. Effect of Goodwill on firm performance

The following table documents the effect of Goodwill on firm performance in the MENA region (Morocco, Jordan, Bahrain, Egypt, Kuwait, United Arab of Emirates, Saudi Arabia, and Qatar.). The period of analysis is from 2005 to 2015. The panel data regression with fixed effects is performed using Equation (1). The coefficients with 1% significance are followed by ***, coefficient with 5% by **, and coefficients with 10% by *.

	Equation (1)
Goodwill	-0.0083***
Goodwill*Goodwill	0.0045***
EVA	0.0233***
SIZE	0.9873***
LEVERAGE	0.0022
VOLATILITY	-0.0387**
PoR	0.03443**
GROWTH	0.0322**
Year Dummies	Yes
No. of Observations	432
F-Value	23.11
R^2 within	0.5211

We re-estimate Equation (1) for different sub-samples. Results of our analysis are shown in Table 4.

We report that our results hold true in both civil law and common law countries, keeping in mind that the majority of our sample observations belong to the common low. Therefore, segregating our sample by legal traditions didn't bring up new conclusions. However, for the size and leverage, firms with high leverage and large size had demonstrated a positive coefficient for GOODWILL*GOODWILL and a negative one for GOODWILL at a significant level. On the other hand, low leverage and small size firms didn't bring up any new conclusions.

Both of these groups have lower information asymmetries. Larger firms enjoy high levels of Goodwill. Our results are aligned with the results of Dharan (1996). This former had performed a study about US listed companies where he was able to demonstrate that firms with highest total assets value have the highest Goodwill-to-assets ratio. Regarding leverage, the same conclusions can be drawn for firms with high debt, where GOODWILL coefficient is negative and significant while GOODWILL*GOODWILL coefficient is positive and significant. R^2 ranged 32% and 62%. Goodwill is more value relevant in sub-samples of firms with low information asymmetries (high leverage and large size) while it is not at all significant nor relevant in firm with high levels of information asymmetries (low leverage and small size).

Table 4. Effect of Goodwill on firm performance in different sub-samples

The following table documents the effect of Goodwill on firm performance in different sub-samples (Large/Small, High Leverage/Low Leverage, Common Law/Civil Law). The sample comprise of firms from the MENA region (Morocco, Jordan, Bahrain, Egypt, Kuwait, United Arab of Emirates, Saudi Arabia, and Qatar.). The period of analysis is from 2005 to 2015. The panel data regression with fixed effects is performed using Equation (1). The coefficients with 1% significance are followed by ***, coefficient with 5% by **, and coefficients with 10% by *.

	Size		Leverage		Legal Traditions	
	Large	**Small**	**High**	**Low**	**Common Law**	**Civil Law**
Goodwill	-0.0584***	-0.0733	-0.1037***	-0.0436	-0.0342*	-0.0945*
Goodwill*Goodwill	0.0073***	-0.0384	0.0071***	0.0060*	0.0072**	0.0034**
EVA	-0.0168**	0.3197***	0.0310*	0.0377***	0.0630***	0.0076***
SIZE	0.819**	0.3323**	0.7435***	0.8241***	2.1738***	0.7937***
LEVERAGE	0.0039**	-0.0047*	0.0032*	-0.0039*	0.01730*	0.0072*
VOLATILITY	-0.0331***	-0.0279***	-0.0343	-0.0384***	-0.0493***	0.0078*
PoR	0.0073**	-0.0004*	0.0018**	0.0034**	0.0034**	0.0034*
GROWTH	0.0049**	0.0031***	0.0072***	0.0015**	0.0027**	0.0030***
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes
No. of Observations	275	157	255	177	312	120
F-Value	33.10	29.71	37.33	17.74	34.80	17.37
R^2 within	0.4435	0.3472	0.4308	0.4454	0.6238	0.3218

5. DISCUSSION OF RESULTS

Our results show that high level of goodwill has a positive impact on firm performance. We argue that high level of goodwill are translated into firms with high levels of performance, only good performing firms invest in goodwill while small merely struggle to generate tangible assets.

In order to test our assumption, we introduce two more variables in Equation (1). These variables represent interaction between goodwill and economic added value (GOODWILL*GOODWILL) and interaction between square of goodwill and economic added value (GOODWILL*GOODWILL*EVA). Our modified equation takes the following form:

$$\begin{aligned} RET = {} & \alpha + \beta_1(GOODWILL) + \beta_2(GOODWILL*GOODWILL) + \beta_3(EVA) + \beta_4(GOODWILL*EVA) + \beta_5(GOODWILL*GOODWILL*EVA) \\ & + \beta_6(SIZE) + \beta_7(LEVERAGE) + \beta_8(VOLATILITY) + \beta_9(PoR) + \beta_{10}(GROWTH) + \sum_{Yr} \beta^{Yr}(YDUM) + \varepsilon \end{aligned} \quad (2)$$

The results of our analysis are reported in Table 5. As expected, our results are aligned with our previous conclusions at a more prominent level. GOODWILL coefficient was still negative but insignificant. However, GOODWILL*EVA coefficient turns to be positive. Concerning GOODWILL*GOODWILL coefficient, it is still positive as expected but at less significance compared to GOODWILL*GOODWILL*EVA coefficient. Introducing EVA to our goodwill variables in order to capture the interaction in between had only strengthened our conclusions and made them more robust.

Table 5. Effect of Goodwill on informativeness of earnings

The following table documents the effect of Goodwill on informativeness of earnings in the MENA region (Morocco, Jordan, Bahrain, Egypt, Kuwait, United Arab of Emirates, Saudi Arabia, and Qatar).The period of analysis is from 2005 to 2015. The panel data regression with fixed effects is performed using Equation (2). The coefficients with 1% significance are followed by ***, coefficient with 5% by **, and coefficients with 10% by *.

	Equation (2)
Goodwill	-0.3897
Goodwill*Goodwill	0.0044**
EVA	1.4400*
Goodwill*EVA	0.9831*
Goodwill*Goodwill*EVA	0.0033***
SIZE	0.9842***
LEVERAGE	0.0034
VOLATILITY	-0.4400**
PoR	0.0044**
GROWTH	0.0090***
Year Dummies	Yes
No. of Observations	432
F-Value	30.33
R^2 within	0.6527

6. CONCLUSION

Though goodwill is an intangible asset, it has been demonstrated to increase corporate worth and to provide sustained competitive advantage (Tan, 2007).

This research paper documents the impact of goodwill on firm performance in the MENA region during the period between 2005 and 2015.

The results of our analysis show that high level of goodwill has a positive impact on large firms' performance. We demonstrate that high levels of goodwill are translated into high levels of performance. Yet, at small firms, goodwill was not proved to impact performance. This can be explained by the fact that only good performing firms invest in goodwill while smaller firms simply struggle to generate tangible assets. We also show that our results hold across different sub-samples characterized by different characteristics. For instance, our results are qualitatively the same in both civil law and common law countries, keeping in mind that the majority of our sample observations belong to the common low. Therefore, segregating our sample by legal traditions didn't bring up new conclusions. However, for the size and leverage, firms with high leverage and large size had demonstrated a significant impact only at high levels of goodwill. On the other hand, low leverage and small size firms didn't bring up any new conclusions. We introduced the economic added value (EVA) to our goodwill variables in order to strengthen our previous conclusions. The results show similar conclusions and made them more robust.

7. LIMITATIONS

Definition of goodwill was one of our main limitations; we didn't want to get into the accounting specifications of goodwill. Different accounting systems define goodwill differently; some would include research and development, others wouldn't; in our study we tried to focus purely on the amount of goodwill that is mentioned on the balance sheet, regardless of the components that were included under this account. Moreover, the availability of data was one of our main limitations, especially when discussing such a topic in MENA region.

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