SA20055

Empirical Evidence on the Effect of Treasury Stock Purchases on Reported Earnings Per Share

Paul Wertheim, Ph.D.
Professor of Accounting
College of Business Administration
Abilene Christian University

Jonathan D. Stewart, Ph.D.
Professor of Finance
College of Business Administration
Abilene Christian University

Submitted for presentation at the Academic and Business Research Institute Conference
San Antonio, TX, March 19-21, 2020

Please send correspondence to:

Paul Wertheim
Abilene Christian University
ACU Box 29311
Abilene, Texas 79699
e-mail: paul.wertheim@acu.edu
325-674-2071

SA20055

Empirical Evidence on the Effect of Treasury Stock Purchases on Reported Earnings Per Share

ABSTRACT

Corporate stock repurchases have experienced huge popularity among publicly traded companies during the last decade. For example, Amenta (2013) reports that during the twelve months ending September 30, 2013, stock repurchases increased by 32% year-over-year with a total of $448.1 billion spent by companies in the S&P 500. In February, 2014, Apple Inc. announced that they repurchased $14 billion worth of their common stock in a two week period and had spent $40 billion on buybacks during the previous 12 month period (Wakabayashi, 2014).

Since 2008, as firms dedicated more dollars to repurchasing their own shares, the S&P 500 enjoyed a spectacular increase in Earning Per Share. For example, the 2008 EPS for the S&P 500 was $18.19. By September of 2019, EPS for the index had risen to $133.01.

This paper seeks to investigate the effect that stock repurchases have had on the dramatic increase in EPS. The popular press and academic research have looked at different aspects of stock repurchases. Much of the literature suggests that stock repurchases may be used to manage a company's earnings per share. Caster et al. (2006) focuses on the fact that the compensation of many top executives is based on performance goals. Often these goals are based on EPS. This may provide a strong incentive for executives to attempt to manage EPS through activities such as stock repurchases. It may also encourage firms to raise capital using financial instruments that do not have a dilutive impact on EPS.

Hribar et al. (2006) make this really important point: "Firms are not required to provide, and most do not volunteer, details about the timing, price, or volume of their individual repurchase transactions. Consequently, analysts and investors typically learn about open-market repurchase transactions only indirectly from quarterly or annual report disclosures about firm cash flows and shares outstanding. The inherent flexibility of open-market buybacks, coupled with their limited visibility to analysts and investors, makes this type of stock repurchase particularly well suited for use as an EPS management device."

Myers et. al. (2007) investigate firms that report long "strings" of consecutive increases in EPS. They find these strings persist longer than would be expected by chance and take this as evidence of earnings management. They find evidence of significant abnormal returns for firms which maintain long strings of EPS increases. These abnormal returns disappear quickly when the string is broken.

However, Oded and Michel (2008), argue that the idea stock repurchases enhance EPS is false. They illustrate this belief with a numeric example under perfect market conditions. They conclude that the choice to accumulate cash, repurchase shares or pay a dividend will have differential impacts on the firm's stock price and EPS, but will not have a significant impact on shareholder wealth as a whole. They argue that stock repurchases may distort investor perception by increasing EPS without improving operating performance. Similarly they argue that dividend payments may result in a misleading decline in EPS which is also not related to a change in operating efficiency.

The purpose of this paper is to: (1) provide a descriptive analysis of treasury stock repurchases from 2008 through 2019, and, (2) examine the effect that stock repurchases have had on changes in EPS since 2008. Using data from the Compustat database, we compare "*reported*" EPS with a "*recalculated*" EPS for each company in the sample after eliminating the effect of treasury stock purchases. As part of this analysis, we calculate the portion of EPS growth during the time period that can be attributed to stock repurchases. We find that a large percentage of EPS growth for companies for 2008 through 2019 has come from stock repurchases, and that the effect of stock repurchases has accelerated in recent years. Such information is useful to investors as they evaluate the relationship between earnings per share and stock price, and particularly the effect that stock repurchases have on EPS growth for a company.