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ACCOUNTING PRINCIPLES AND PRACTICES

Goodwill Amortization and the Usefulness of Earnings

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Abstract

This study provides evidence of the effect of goodwill amortization on the usefulness of earnings data as an indicator of share value for a large sample of publicly traded companies over the 1993–98 period. This issue is of special interest because the

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over a period not to exceed 40 years. Critics have argued that goodwill may not decline in value and that, even if it does, the arbitrary amounts recorded periodically as goodwill amortization are unlikely to reflect that decline. In this view, goodwill amortization simply adds noise to earnings, thereby reducing their usefulness to investors. Accounting standard setters, in contrast, have until recently maintained that goodwill is likely to be a wasting asset in most circumstances and that recording goodwill amortization makes reported earnings more useful to investors by reflecting its decline in value. We provide empirical evidence as to which of these views is more consistent with the way in which investors price securities.

This issue is of current interest to investors and analysts because of a recent change in the accounting rules for purchased goodwill. Under Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, the reported earnings of acquiring companies will no longer include charges for goodwill amortization. Goodwill acquired in a business combination is recognized as an asset, as in the past, but once it is recognized, the asset remains on the balance sheet indefinitely, subject only to review for impairment when circumstances warrant. Thus, the question arises of whether excluding goodwill amortization from reported earnings will enhance or detract from its usefulness to investors.

To investigate this issue, we document the extent to which variation in stock prices is explained by earnings before goodwill amortization and by reported earnings, which includes goodwill amortization. Our analysis, based on a large sample of publicly traded companies reporting purchased goodwill in the six-year period of 1993–1998, involved comparing earnings per share before goodwill amortization with reported earnings. In interpreting the results, we must be careful not to attribute all value-relevant variation in stock prices to the variation in earnings before goodwill amortization or to the variation in reported earnings. Our results show that the accounting rules for goodwill amortization have a significant effect on the variation in earnings before goodwill amortization and on goodwill amortization, we found that the estimated coefficient



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