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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 Financia ... ndards that eliminat ... to review goodwill ... gs before goodwill ... of share prices th ... tions are based ... easure. Thes ... utation of net inco ... mary indicato

Analysts ... on in their financial ... have criticized the accounting requirement to amortize purchased goodwill against revenues

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 compari [illegible] earnings per share be [illegible] earnings. In interpret [illegible] ct all value-relevant [illegible] the variation [illegible] or of share value.

Our r [illegible] accounting rules for [illegible] ngs before goodwill [illegible] orted earnings [illegible] ally significa [illegible] oodwill amortization and on goodwill amortization, we found that the estimated coefficient (valuation multiple) on earnings before goodwill amortization was large and highly significant whereas the estimated coefficient on goodwill amortization was statistically indistinguishable from zero. This finding strongly suggests that goodwill amortization merely adds noise to reported earnings. Overall, these results indicate that the recently adopted reporting rules for purchased goodwill are likely to increase the usefulness of earnings as a summary indicator of share value.