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Investor Underreaction to Goodwill Write-Offs

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Abstract

Current accounting rules end regular amortization of goodwill and mandate annual tests for goodwill impairment and loss recognition, when appropriate. These rules make consideration of goodwill write-offs important and timely. In the study reported here, we found that the effects of goodwill write-off announcements were typically negative and material—on the order of −2.94 percent to −3.52 percent of the company's stock price. What makes goodwill write-off announcements especially noteworthy for investors is that additional effects of roughly −11.02 percent were realized by the end of a one-year post-ann[...]derreact to goodwill[...]tential for further l[...]

Until[...]and other intangib[...]to intangible assets w[...]ars. Financia[...]ther Intangible Assets, does away with the presumption that acquired goodwill and other

acquired intangible assets have finite lives, however, and eliminates mandatory amortization. Acquired intangible assets that have finite lives will continue to be amortized over their useful lives but without the constraint of any arbitrary ceiling.

Under FASB Statement No. 142 accounting standards, goodwill is to be tested for impairment, at least annually, by using a two-step process. The process begins with an estimation of the fair value of a reporting unit and is a screen for potential impairment. The second step measures the amount of impairment, if any. If the carrying amount of acquired goodwill or acquired intangible assets exceeds fair value estimates, an impairment loss must be recognized against net income in an amount equal to that excess.

FASB Statement No. 142 improves financial reporting by helping users of financial statements understand corporate investments in goodwill and other intangible assets and the subsequent performance of those assets. Adoption of FASB Statement No. 142 is relevant for investors because this statement promises to make goodwill write-offs routine corporate events that are based on a quantitative approach.

This article provides evidence about investor reactions to company announcements of goodwill write-offs. Investor reactions to such write-offs offer evidence about how investors process potentially important information about a company's profit-making potential. Stock price effects associated with goodwill write-offs offer evidence about the extent to which accounting goodwill numbers capture the economic value of intangible factors with assetlike characteristics.

We found statistically significant negative abnormal returns tied to goodwill write-off announcements. Two-day announcement effects for our sample of 80 U.S.-listed companies announcing goodwill write-offs in the 1992–96 period were typically negative and material, on the order of −2.94 percent to −3.52 percent of the company ... nouncement period e... of the negative ... lized after the a... stors must be w... d the potentia... d.