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The Value Relevance of Accounting Goodwill – Does the Abandonment of Systematic Amortization Make Sense to Investors?

This study examines how the length of goodwill amortization period affects firm value. The point of departure for the study is that the International Accounting Standards Board assumes that systematic goodwill amortization over an arbitrary period fails to provide equity investors with useful information. This is supported by most prior studies. With respect to this assumption, International Financial Reporting Standard 3 "Business combinations" abandoned the systematic amortization of goodwill in favor of the impairment-only accounting approach, and hence introduced a major goodwill accounting change for EU listed firms.

In earlier studies the data used are not representative of all jurisdictions because they come from a single country (the US) where very long amortization periods were applied. The amortization periods of the US, often extending to the maximum of forty years, are in sharp contrast with the empirical results on the useful life of intangible assets. For example, R&D investments have generally less than ten years useful life (Lev and Sougiannis, 1996), and the effect of advertising expenditures on subsequent earnings is short-lived: one to two years (Bublitz and Ettredge, 1989).

Until 2004, the main principle of the Finnish Accounting Act set a maximum five-year goodwill amortization period, however, it allowed extending the length of goodwill amortization to twenty-years. This institutional setting is utilized as a laboratory for tests of the value-relevance of the length of amortization period. It enables to examine whether (very) short amortization periods improve the value relevance of the following goodwill accounting items: the systematic amortization of new goodwill, goodwill write-offs, and capitalized goodwill. The sample consists of Finnish listed firms from the period 2001 to 2004. The data used in OLS regressions are from archival databases, complemented by hand-collected data from the annual reports of the sample firms.

The empirical results suggest that all the three goodwill accounting items examined are more value relevant when firms apply a maximum amortization period of five-years in contrast to an amortization period exceeding five years. This study concludes that the goodwill amortization practice does provide relevant information to investors, provided that amortization periods are sufficiently short in order to better reflect the economic life of the underlying assets. Various sensitivity analyses including fixed effects, scale effects and time effects are conducted to check the robustness of the results. ■