

# Subjective Goodwill as a Determinant of Earnings Quality

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## Abstract

*This paper analyses Subjective Goodwill that may relate to accounting earnings quality and its information content. Although the concept of earnings quality has been discussed widely, there is still no agreement about its definition and measurement. Some attributes are sometimes pointed such as time series properties, including persistence, predictive ability and variability, qualitative characteristics of a conceptual framework, the relationships between income, cash, and accruals, and the implementation of decisions. This paper discusses it by comparison with the characteristics specified by the concept of 'released from risks' related to net income in ASBJ (2006).*

*Net income is defined as a portion of the changes in net assets during a certain period that represents the results of investments that are released from business risks during a certain period and are attributable to the owners of the reporting entity. The need for a concept of 'release from a risk' lies in the very objective of financial reporting that is to disclose useful information to assist investors in making decisions. Supposing, as ASBJ (2006) assume, that accounting earnings are useful for investors because certain information in the future are reflected, the key might exist in the accounting accruals which are composed elements of earnings.*

*Subjective goodwill is assumed to be the difference of the value in use and the market price. Value in use reflects the subjective value estimated by the reporting entity, and it consists of a market price and intangible (subjective) goodwill, which is defined as the excess of value in use over the market price. In the present system subjective goodwill is excluded from financial reporting, and this exclusion is supported by many researchers. However, it is necessary to examine the "common sense" that subjective goodwill should not be recognized. Because subjective goodwill included in accounting earnings seems to be the determinant of earnings quality.*

*We found that the portion which is reflected in current accounting income within the converted amount of subjective goodwill is expressed with  $(B_{t-1} - B_t) - (P_{t-1} - P_t)$  by using income measurement model (Edwards and Bell [1968]). This amount is considered to be an error in the allocation of subjective goodwill, and to be the portion in which managerial discretion is reflected. Supposing managerial discretion in measurement operation serves as a means to transmit private information that managers themselves hold, and that the usefulness of accounting income is increased by such information, it is also possible that a certain additional informational content about the future is included in the portion,  $(B_{t-1} - B_t) - (P_{t-1} - P_t)$ . This means there is a possibility that information contents are included in the allocation error itself in which managerial discretion or judgment is included.*

*An argument on quality of earnings is related to the basic concept in financial reporting, and is also closely related to the disclosure system in a capital market. However, despite its importance, there is still no commonly accepted agreement in the definition or measurement of quality of earnings. The various classification methods are intermingled and lack a common perspective on the influence that various characteristics have on the quality of earnings. Since theories of earnings quality often are discussed within the context of value relevance, in this paper, particular attention is paid to the allocation problem in accruals. Thus, quality of net income, specified using the concept of released from business risks, is examined from the viewpoint of the allocation problem of subjective goodwill. This paper clarifies the amount of the allocation error included in accounting income by generalizing the conversion process of subjective goodwill. It is posited that this is a portion of managerial discretion in income measurement, and includes certain informational content that increases the usefulness of accounting income.*

Field of Research: Financial Accounting

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