Abstract

Purpose – Advocates of greater intangible asset reporting frequently make the criticism that the published financial statements of companies do not adequately reflect the value of intangible assets and hence provide potentially misleading information to the users of the financial statements. The purpose of this paper is to evaluate whether since the introduction of “fair value accounting,” particularly in respect of the treatment of acquired “goodwill” shown on consolidated balance sheets, these criticisms retain any validity. The paper investigates the extent to which it can be confidently asserted that the recognition of acquired goodwill and the post-acquisition rules for recognizing any goodwill “impairment” has materially improved the information available to the users of financial statements and/or whether these developments have resulted largely in providing self-interested managers with greater opportunities to engage in earnings and balance sheet manipulations that are of doubtful value to users.

Design/methodology/approach – The paper critically reviews the rules and the intentions of accounting policy makers in relation to fair value acquisition accounting and evaluates the empirical evidence relating to corporate behavior in this area.

Findings – Despite the presumed benefits associated with fair value accounting, it is shown that in practice managerial self-interests and earnings management concerns appear to motivate many goodwill impairment decisions. However, as investors and analysts have always had the option to adjust, or indeed totally ignore, reported accounting numbers it is far less certain whether this reporting behavior actually misleads users or significantly reduces the information content (reliability and relevance) of the financial statements.

Originality/value – The paper provides an overview of the accounting treatment and reporting consequences associated with the introduction of fair value accounting in respect of acquired goodwill.

Keywords Fair value, Accounting, Intangible assets, Goodwill accounting, Managerialism, Strategic choices

Paper type Research paper

Introduction

Despite the fact that the balance sheets produced for financial reporting purposes have never been constructed with the purpose of providing a current “fair value” of the company to an investor, advocates of greater intangible asset reporting frequently make the criticism that by not adequately reflecting the value of intangible assets, these balance sheets provide users – predominantly investors and analysts – with potentially misleading information concerning the “true” value of the company. This paper evaluates whether since the introduction of “fair value accounting” in respect of the treatment of acquired “goodwill” shown on consolidated balance sheets, these criticisms are well founded.
We also investigate the extent to which it can be confidently asserted that the recognition of acquired goodwill and the post-acquisition rules for recognizing any goodwill “impairment” has materially improved the information available to the users of financial statements and/or whether these developments have resulted largely in providing self-interested managers with greater opportunities to engage in earnings and balance sheet manipulations that are of doubtful value to users.

Changing accounting standards and the move to fair value
Accounting standards have changed considerably over the past decade, and this is particularly true with regard to the increasing emphasis placed on reporting assets at fair value (predominantly the current market price of an asset). Relative to the historic cost alternative, the reliability and relevance of fair value-based accounting numbers will be maximized when the assets concerned are being actively traded in liquid markets. Hence, fair value accounting is largely restricted to firms’ holdings of “available-for-sale” and “trading” securities where current market prices are readily observable. The case for using fair values is greatly reduced in cases where the assets are rarely traded, are too complex and/or where they are difficult to separately identify. This is clearly, the situation in respect of post-acquisition goodwill. Whilst goodwill, which is the difference between the purchase price and the estimated fair value of the acquired assets, is relatively easy to observe at the time of the acquisition, post-acquisition changes in its value are not. Though increasing the value of goodwill post-acquisition is not allowed, the annual “impairment” test to determine whether its value has declined provides managers with an immense degree of discretion in regard to reporting whether and by how much the goodwill has been impaired.

It is worth noting that the use of fair value accounting is not restricted to International Accounting Standards (IAS). In the USA for example, fair value amounts are also used for goodwill and other intangible assets under Statement of Financial Accounting Standards (SFAS) 142 and for the impairment or disposal of long-lived assets (SFAS 144). However, the adoption of IAS has played a significant role in the application of fair value accounting globally. In the European Union (EU) for example, the mandatory adoption of IAS in 2005 has resulted in intangible assets (IAS 38), goodwill from business combinations (IAS 3), and derivatives and financial instruments (IAS 39) being reported at fair value across Europe. In carrying these items at fair value the underlying premise is that the reporting of asset values in line with market values increases the relevance and usability of financial accounts for financial statement users[1]. However, the reliability of fair values has been subject to a considerable amount of criticism and, as mentioned above, this is especially true in relation to intangible assets (Barth and Landsman, 1995).

One of the major difficulties in this area concerns the fact that local generally accepted accounting principles (GAAP) in several European countries have evolved over long time periods and arguably they reflected the specific accounting needs of these countries given their particular industrial and corporate structures and regulatory and legal environments. For example, the distinction between bank and shareholder-based systems is often employed when analyzing how local accounting and reporting structures are designed. Nobes (1998) separates countries into Classes A and B regimes, or Anglo-Saxon and continental European, whilst Richard (1996) uses the distinction to
argue that Anglo-Saxon accounting regimes tend to be more open and dynamic than the continental European systems.

The Anglo-Saxon view of the purpose of financial accounting and reporting is that it is primarily an attempt to provide a true and fair view (TFV) of the financial position and performance of the corporation. This objective produces a strong focus on shareholder interests and providing useful disclosures for investor decision making. However, in bank-based economies such as Germany for example, the focus of financial reporting and related disclosures are more focused on creditor concerns. As a result, local GAAP tended to reflect the different needs of the primary suppliers of finance in the respective countries. However, in reflecting the different needs of the users of financial accounts, local-GAAP limited the ability to undertake meaningful cross-country comparisons. Indeed, one of the main and most fundamental differences between the Anglo-Saxon and continental approaches that limited international comparability concerned the very concept, definition and valuation of an asset!

Not surprisingly, the demand for harmonized global financial accounting has greatly increased over recent years due, as Flower and Ebbers (2002) note, to the desire by international investors and governments for increased transparency in financial reporting and for increased comparability of financial statements both within Europe and also globally. However, the concept of fair value accounting is a key feature of the Anglo-Saxon accounting system under International Financial Reporting Standards (IFRS). As a result, the push for conversion to IFRS fundamentally changed the accounting principles and practices of many continental financial reporting systems.

For example, in regard to the value of assets, the resultant blanket adoption of IFRS, whereby assets can be valued at their cost on acquisition, their production or at their current value, leads to many instances where the current value will be in excess of the historical cost. This has caused big changes to local German GAAP which, being embedded in a bank-based corporate governance system and as a consequence focused primarily upon creditor protection, had long prevented valuation above historical cost (Walton et al., 1998).

There is also evidence that the aspiration to join the EU (the fourth and seventh Directive[2]) contributed to the decision by countries to adopt IFRS (Robert, 2000). One of the most significant amendments to the content of the Directives was the requirement for a TFV[3] after Great Britain and Ireland entered the EU. Specifically, Article 2 of the Directive requires accounts to be prepared in accordance with the Directive’s provisions and to give a TFV otherwise additional information must be provided.

As a result of the increasing reliance on IFRS, the use of fair value shareholder-focused accounting in theory should have increased transparency and comparability across countries. However, this is only true, if the correct valuation of assets occurs. A number of structural, cultural, and behavioral factors, however, suggest that this has not been and will not be the case any time soon. Essentially, certain assets are complex and difficult to value and this is clearly the case when intangible assets, which are of increasing relative importance on balance sheets, are considered. In addition, accounting rules necessarily provide managers with a wide degree of discretion regarding which rules to apply and what trade-offs to make between reliability and relevance of the information provided. Moreover, as managers are self-serving, this discretion may be exploited since it provides both the opportunity and incentives for them to decide when to inflate asset values, or to postpone revaluation.
Accounting for intangibles

Intangible assets are the most difficult to value in acquisition accounting, and this problem is particularly acute where there has been a significant amount of previous accounting manipulation (Caldwell, 2006). One possible reason for this is the unique and non-separable nature of intangible assets. A wide variety of intangible asset classes are found across firms and their value is closely related to – indeed, in many instances, inseparable from – the firm’s underlying business model and operations (Wyatt et al., 2001). In such situations, the relative contribution and value of seemingly similar intangible assets to the firm can vary considerably.

Barth et al. (2001b) note that the prices of firms with high-intangible assets tend to be less informative. Analysts therefore allocate greater time and effort to the valuation of firms with higher intangible assets. The complexity of intangibles assets has been widely discussed in financial accounting research and most accounting researchers conclude that accounting for intangible assets is inevitably one of the most controversial and intractable issues in accounting (Wines and Ferguson, 1993; Jennings et al., 1996; Choi et al., 2000; Alferdson, 2001; Godfrey and Koh, 2001).

One of the most complex and controversial intangible assets is goodwill. At its most basic goodwill is an acquisition premium. Goodwill is the cost above the fair value of a firm once all the assets of the firm have been stated at fair value. IAS 3 is the IFRS for accounting for goodwill from business combinations and is generally consistent with the US standard SFAS 141[4].

One of the most important features of how goodwill is accounted under IAS 3 is the process by which goodwill is impaired. Unlike other tangible assets such as property that can be revalued both up and down with fluctuations in market prices, goodwill cannot increase in value and any impairment of goodwill is permanent. As such this creates incentives to time goodwill write-downs or even postpone impairment as any fall in value is charged against the current period’s profits.

The impairment test for goodwill should be carried out in accordance with IAS 36. Forbes (2007) examined the application of IFRS 3 in the FTSE 100 for acquisitions in the first year of adopting IFRS 3. The results showed that over half (£21 billion) of the acquisition amount (£40 billion) was unaccounted for and placed into goodwill without explanation regarding what this £21 billion represented. The cases examined were: WPP, which assigned goodwill at some three times greater a value than the tangible assets it acquired when it took over Grey Global Group; BAE Systems assigned 84 percent of the purchase price of United Defense; and Arriva’s acquisition of RAC resulted in 80 percent of the acquisition value being identified as goodwill. These cases highlight both the problems associated with trying to decompose goodwill and how significant it is as an asset of the firm.

Motivations for undertaking impairment

A considerable literature on goodwill impairment behavior has developed since the move to fair value accounting. Most studies have attempted to investigate the motivations of managers to revalue assets (Henderson and Goodwin, 1992; Whittered and Chan, 1992), the impact of revaluation announcements on share prices, and the future profitability of the firm (Sharpe and Walker, 1975; Standish and Ung, 1982; Emanuel, 1989; Easton et al., 1993; Aboody et al., 1999). The most important determinant of write-down decisions are managerial incentives. These include a change in senior
management where an external chief executive is appointed, the firm’s capacity to absorb the financial statement effects of the write-down and current market conditions (Strong and Meyer, 1987; Cotter et al., 1998) and the capital budgeting decision (Robichek and Van Horne, 1967; Dy1 and Long, 1969; Gaumnitz and Emery, 1981).

Watts (2003) explains that managers will use discretion in situations where they have agency-based motives to do so. For example, Beatty and Weber (2006) found that firms undertake goodwill impairment when they have less slack in the net worth covenant, smaller earnings-based bonus plans, shorter CEO tenure, and higher earnings response coefficients on income from continuing operations. There are two main motivations cited for managers to deciding to undertake impairment. The first is to turn the firm around (Dechow and Ge, 2006) and second incentive is firm reorganization. However, reorganization creates a permanent loss in revenue in future years (Ramanna and Watts, 2009).

However, the write-down decision can also be a signal of firm performance from management to investors. A number of studies have shown the existence of a relationship between write-offs and stock returns, i.e. Strong and Meyer (1987), Elliot and Shaw (1988) and Rees et al. (1996). Likewise, Ahmed and Guler (2007) find that goodwill write-offs and goodwill is associated with stock returns. This suggests that the impairment is value relevant and is therefore reflected in firm stock prices. The value relevance of impairment is also supported by the evidence of Li et al. (2005) who find that analysts revised their expectations downward on an impairment loss.

One reason for stock prices reflecting the impairment of goodwill write-off is that it is closely related to economic factors. Jarva (2009) for example finds that goodwill impairments have significant predictive ability for both the one and two year cash flows of the firm. However, Barth et al. (2001a) argue that market-based tests of value relevance provide only indirect evidence about the information contained in the impairment decision as share prices are assumed to be a proxy for expected future cash flows. Moreover, the market reaction to goodwill write-offs appears to be a function of firm size. For example, Bens et al. (2007) find that the limited resources within small firms increase the measurement error of goodwill write-offs and so the market reaction tends to be less significant for small firms.

**Do impairment announcements contain information?**

Changes in accounting standards for impairment have important implications for decisions about asset values as well as reported income. On one hand, the revaluation decision may not typically coincide with changes in tangible assets or cash flow (Hirschey and Richardson, 2002) and so there is a timing issue. Moreover, the revaluation decision may be a signal of firm’s future earnings potential and can therefore be both a positive or negative signal about the firm (Bartov et al., 1998; Ritter and Wells, 2006). However, the clarity of this signal is unclear. As Schipper (2005) notes, reported results are likely to have a higher volatility when using fair value measurements.

With regard to intangibles, Docking et al. (1997) stated that write-offs are similar to bank loan-loss reserves. SFAS 142 requires the estimation of the fair value of the asset to determine goodwill impairment instead of goodwill amortization. In addition to this, goodwill is subject to an annual impairment test (Davis, 2005). Goodwill is therefore impaired if the fair value of goodwill is less than its book value, so that the users of financial statements can better assess future profitability and cash flows. Chen et al. (2004)
find that impairment losses were partially estimated by the market prior to the adoption of SFAS 142, while Bens and Heltzer (2004) find that the application of SFAS 142 does not change the information content or the timeliness of goodwill write-offs. However, as a result of the annual test the frequency and magnitude of goodwill write-offs have increased significantly.

Empirical findings on the market reaction to asset impairment are mixed. Strong and Meyer (1987), Elliott and Shaw (1988) and Francis et al. (1996) find impairment conveys information about decreases in the economic value of assets. This is borne out by the average cumulative abnormal returns being negative around the announcement date of impairment. Many studies for both US and non-US markets report that the effect of a goodwill write-off is typically negative and has material impact on the firm’s stock price and investors initially under-react to the write-off (Hirschey and Richardson, 2002, 2003; Segal, 2003; Triest and Weimer, 2003; Lapointe-Antunes et al., 2006). Further, analysts revise their earnings forecasts downward following the announcement of impairment losses (Li et al., 2005[5].

Managerial discretion and impairment
The move from historical cost accounting to fair implies greater managerial discretion over the actual value of an asset. Further, issues such as illiquidity in asset prices or volatility in asset prices confound the issues of what is the current price of a given asset. If observable prices are not available from an active market, current standards allow the reporting entity to estimate the value of an asset. Rees et al. (1996) highlight the fact that managerial estimation of fair value is likely to determine the amount of an asset’s write-down due to the absence of quoted market prices for many firm-specific assets. The calculation of impairment is therefore subject to manipulation and may be unreliable due to the management’s estimation (Bloom, 2009).

Unreliability and value irrelevance of accounting numbers may therefore be an issue that is a direct consequence of the management’s incentives to bias any measurement of asset values (Holthausen and Watts, 2001). This discretion has a much more significant impact on the estimation of intangible asset values as opposed to tangible assets.

The write-off decision is also a trade-off for managers between recording certain current goodwill impairment charges below the line, and facing uncertain future impairment charges included in income from continuing operations (Beatty and Weber, 2006). In other words, there may be a trade-off between reliability and relevance toward applying fair value accounting. This is confirmed by Dahmash et al. (2009) as the information about goodwill and intangible assets is value relevant, but not reliable.

However, some studies provide evidence that managerial discretion about the treatment of intangible assets is beneficial due to the reduction in the errors or biases with which intangible assets are reported Jenning et al. (1996), Choi et al. (2000) and Godfrey and Koh (2001). This suggests an improvement in reliability as managers can use their judgment to convey private information about the value of the firm’s assets.

Another issue is not just the reporting of impairment but the timing, magnitude, and presentation of write-offs all of which are determined by management. Riedl (2004) and Henning et al. (2004) specify that the discretion over the timing of write-offs increased after SFAS 142 because the standards allow managers to more easily justify their reporting choices. This therefore creates a significant problem as there is considerable
evidence that when accounting standards enable managers to exercise judgment, earnings management is more likely to occur (Healy and Wahlen, 1999; Nelson et al., 2002; Nelson, 2003).

Many studies have found a relationship between goodwill impairment and earnings management as well as changes in managerial strategy (Hambrick and Fukutomi, 1991; Barnett and Tichy, 2000; Miller and Shamsie, 2001; Ganes-Ross, 2002). For example, a new CEO has the incentive to lower earnings at the beginning of their tenure to make increased performance under their stewardship more achievable (Pourciau, 1993). Sevin and Schoroeder (2005) find significantly lower performance in the year of in which impairment occurs relative to those who do not undertake impairment, which is evidence of big bath earnings management. Likewise, Masters-Stout et al. (2008) find that CEOs typically decide to recognize goodwill impairment early in their tenure to allow them to blame the previous management team. Moreover, future earnings tend to look better by early expensing. In other words, goodwill impairment appears to be used to a significant degree as an earnings management tool.

**Conclusion**

Intangible assets, and in particular goodwill from business combinations, are an increasingly important element of published consolidated balance sheets. Despite there now being considerable uniformity in accounting standards as a result of the global move towards IFRS, in practice, different regulatory and cultural incentives and practices result in less comparability than would otherwise be the case. These problems are also exacerbated by both the level managerial discretion afforded to managers under the current accounting standards, and by agency-conflicts within firms.

Nowhere is this more apparent than in the case of goodwill accounting. This arguably occurs for two main reasons; first, the increasing importance of goodwill from acquisitions to the overall firm value. For example, in 2008 the net assets of The Royal Bank of Scotland were £91.5 billion. However, the total goodwill recorded in the balance sheet was an estimated £48.5 billion making it over 50 percent of the net assets of the firm. Subsequently, RBS had to write-down the value of its assets by £28 billion, of which £20 billion was a result of goodwill impairment. Second, where uncertainty and managerial discretion are combined, asset impairment decisions appear to be largely driven by income smoothing concerns. Typically, empirical results from research in this area suggest that corporate performance has been smoothed, thus understating the true underlying volatility of corporate business operations. In particular, it seems that management are particularly resistant to recognizing asset impairments, though several recent impairment decisions, e.g. Vodafone’ recent write-off of several billion pounds of goodwill (it had already written-off £26 billion in 2006) arising from its acquisition of Mannesman in 2000, suggest that managers may be increasingly willing to use the financial crisis and the declining market to finally write-off the reported goodwill from long-standing poor acquisitions.

**Notes**

1. Cash and near cash equivalents are also, of course, shown at their current market values.
2. The Directive is the EU law, which is directly applicable to all member countries.
3. According to the Financial Accounting Standard Board, fair value is defined as the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties. This concept is also accepted by the International Accounting Standards Board and contained in the IFRS, which the EU adopts.

4. Other intangible assets fall under IAS 38, which is compatible with SFAS 142.

5. However, some studies report insignificant market reaction, for example Hogan and Jeter (1998) and Zucca and Campbell (1992). These studies are however in a minority.

References


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