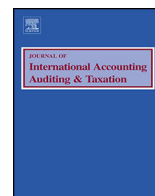




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Changes in the value relevance of goodwill accounting following the adoption of IFRS 3



Mattias Hamberg^{a,1}, Leif-Atle Beisland^{b,*}

^a Norwegian School of Economics, 5045 Bergen, Norway

^b University of Agder, 4604 Kristiansand, Norway

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ABSTRACT

This study examines the value relevance effects of changes in goodwill accounting in a European setting. International Financial Reporting Standard (IFRS) 3 replaced accounting rules that emphasized goodwill amortization over short useful lives which kept goodwill balances low. Goodwill accounting under IFRS 3 largely relies on manager fair value estimates of acquired business units. Using Swedish data, we show that goodwill amortizations were not value-relevant prior to the adoption of IFRS 3. However, impairments reported in addition to amortization were significantly related to stock returns during that period. In contrast, under the impairment-only regime prescribed by IFRS 3, impairments are no longer statistically related to stock returns.

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1. Introduction

The introduction of IFRS 3 in 2005 substantially changed the accounting treatment of business combinations. As reported by Hamberg, Paananen, and Novak (2012), the European adoption of IFRS 3 had large effects on financial reporting. In their Swedish sample, average goodwill balances increased by 50 percent (measured relative to total assets) from 2003 to 2007, and an important reason for this increase was the abolishment of goodwill amortization. In this study we examine how changes in accounting for business combinations affect the value relevance of accounting information in a European setting. More specifically, we investigate how a switch from an amortization-and-impairment regime to an impairment-only regime influences the association between reported goodwill figures and security prices. Our study is motivated by the fact that changes in accounting standards have different value relevance effects depending on the specific regulations of the prior standards, as well as differences in the prevailing institutional settings.

Our empirical results suggest that goodwill balances are positively associated with stock prices in both the Swedish GAAP and IFRS periods. However, goodwill amortizations were not associated with returns and prices in the Swedish GAAP period. These results may indicate that the adoption of an impairment-only approach is sound. There are, however, substantial differences in the value relevance of goodwill impairments. Under the Swedish GAAP, the goodwill impairment coefficient is significantly negative. However, after the adoption of IFRS 3, the coefficient is not significant. Although the data themselves

* Corresponding author. Tel.: +47 97 53 62 63.

E-mail addresses: mattias.hamberg@nhh.no (M. Hamberg), leif.a.beisland@uia.no (L.-A. Beisland).

¹ Tel.: +46 732 520353.

do not indicate why goodwill impairments transition from being value relevant under Swedish GAAP to not being value relevant under IFRS, several explanations for the change are presented and discussed in the paper.

The remainder of the paper is organized as follows. Section 2 describes the institutional framework, as well as the research hypotheses. Section 3 presents the research methodology and sample characteristics. Section 4 presents the empirical analysis, in which we examine the associations between goodwill accounting and stock prices and returns. Finally, Section 5 discusses the findings and concludes the analysis.

2. Background

2.1. The regulatory framework

Accounting regulators recognize acquired goodwill but not internally generated goodwill. This difference can be attributed to the verifiability of acquired goodwill arising from open market transactions. In principle the value of goodwill is measured as the difference between the purchase consideration and the fair value of the identifiable net assets. Therefore, goodwill is considered an indicator of excess future cash flows from either the acquired entity itself or a combination of the acquired and acquiring entities.

Accounting for business combinations has changed dramatically since 2000. This process began in the U.S. when the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 141 and SFAS 142 in June 2001. IFRS 3 became active in January 2005, the same time as the European mandatory adoption of IFRS. New features of IFRS 3 include the abolition of the pooling method, the abolition of goodwill amortization, and the adoption of an impairment-only approach.

According to [Van der Zanden and Nobes \(2002\)](#), most European standard-setters previously allowed firms a choice between the purchase and pooling methods for business combinations in the pre-IFRS 3 era. While the purchase method gave rise to goodwill and affected future earnings, the pooling method did neither. Eliminating the choice between the two accounting methods reduced managerial discretion. However, changes in the application of the purchase method may have actually *increased* overall discretion in goodwill accounting.

Prior to IFRS 3, goodwill was largely the difference between the purchase price and the book value of the acquired firm's equity. This is no longer the case under IFRS 3. Instead, at the time of the acquisition, the management identifies specific intangible assets in the acquired entity (such as patents, licenses and trademarks) that are to be capitalized separately. Depending on the nature of these intangibles, they can be held indefinitely or amortized over a maximum useful life of up to 20 years.

In the past, goodwill usually was amortized over its useful life. This time period varied significantly between local GAAP (e.g., the U.S. allowed a maximum of 40 years and International Accounting Standards permitted firms a period up to 20 years). Most European firms employed short useful lives ([Van der Zanden & Nobes, 2002](#)). Prior to 2002, the Swedish accounting standard RR 1:96 required goodwill to be amortized over five years unless a longer useful life could be estimated with reasonable certainty (as required by Swedish law: ÅRL 4:2–4). In 2002, when Redovisningsrådet issued RR 1:00 in response to a revision of [International Accounting Standard \(IAS\) 22](#), the useful life was increased to 20 years. However, [Hamberg et al. \(2012\)](#) document that in 2004 a majority of Swedish firms still employed a maximum useful life of less than ten years.

Because IFRS 3 abandons goodwill amortizations, the book value of goodwill must be tested for impairment on a regular basis in accordance with IAS 36, i.e. the carrying amount of a cash-generating unit's goodwill is compared with its recoverable amount. [Petersen and Plenborg \(2010\)](#) corroborate that most firms measure the recoverable amount as the value-in-use and that estimates therefore rely on management's own assumptions. Even if abandoning goodwill amortizations substantially changed goodwill accounting in Sweden, the impairment test procedure suggested by IAS 36 was not unknown at that time. Swedish standard-setters adopted an almost identical standard (RR17) shortly after the release of IAS 36 in 2002.

2.2. Prior research, motivation and hypotheses

Theory on management disclosure suggests that disclosure decisions reflect both informational (signaling) and opportunistic motivations ([Healy & Palepu, 2001](#)). We expect that the adoption of IFRS 3 influenced management's disclosure motivations and that the new standard consequently affected the association between accounting information and security prices. Informational and opportunistic motivations are likely to affect the amounts of both goodwill amortization and goodwill impairment. In this section, we first briefly discuss how changes in the accounting for goodwill amortizations affect value relevance. We then discuss the implications of the changes in the accounting for goodwill impairments. However, because amortizations-plus-impairments are replaced by an impairment-only regime, it is impossible to completely separate the two items from one another in hypothesis development.

Goodwill amortizations are mechanical reductions in the book value of goodwill, and because management does not assess whether the goodwill amortizations reflect the value reduction of the goodwill asset, it has been argued that goodwill amortizations do not convey private information on future cash flows to the market. Research on the association between goodwill amortizations and stock prices is not extensive, primarily because US firms historically did not separately disclose goodwill amortization amounts ([Duvall, Jennings, Robinson, & Thompson, 1992](#)). However, because firms reporting under Accounting Principles Board (APB) Opinion No. 17 usually applied long useful lives, the amortization amounts are likely

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