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Executive compensation and goodwill recognition under IFRS: Evidence from European mergers

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A B S T R A C T

Based on principal agent theory we posit that managers account for a business combination opportunistically by recognizing goodwill in excess of its economic determinants. We examine the relationship between CEOs' short-term cash bonuses and the amount of goodwill recognized in IFRS acquisitions. We find that with increasing cash bonus intensity managers recognize more goodwill. More detailed analysis indicates that this relationship is not a linear one. Instead, there seems to be a corridor in which CEOs are susceptible to the incentive given by bonus payments. In particular, the relationship seems to be fulfilled only for CEOs whose cash bonus is between 150% and 200% of their base salary prior to the acquisition. Our findings have an implication for companies that bonus caps should be introduced to limit CEOs' bonuses to a given percentage of their base salary. By doing so, they may re-align shareholders' and managers' interests and avoid an increased impairment risk in the future.

1. Introduction

Principal agent theory (Fama, 1980; Jensen & Meckling, 1976) suggests that the separation of ownership and control creates a fundamental problem in organizations since interests of shareholders, who want to maximize the value of their equity, diverge from those of managers, who want to be paid more while working less. To re-align these interests, organizations aim to employ optimal pay-for-performance mechanisms.

A company's accounting performance as disclosed in audited financial reports plays an important role when determining the level of executive compensation. However, the flexibility – or discretion – in accounting standards introduces the problem of earnings management. Johnson and Revsine (1988) indicate two perspectives in this regard. One emphasizes that accounting reports can be used by managers to communicate their private information on future cash flows. Consequently, managers use discretionary choices to increase the information content of accounting. The second perspective is based on the view that managers are opportunistic and use discretionary accounting choices for their personal wealth. Thus, accounting decisions may be heavily influenced by executive compensation arrangements.

This latter explanation has led to a large body of research on managers' accounting choices as a result of incentives given by compensation contracts.[1] We base our research on this perspective, which is also termed the bonus plan hypothesis (Watts & Zimmerman, 1986). More specifically, our study examines whether managers' compensation provides an incentive for them to use their discretion potential regarding the recognition of goodwill.

Managers' compensation typically consists of different components: a base salary, a short-term (and sometimes a mid-term) bonus as well as a long-term incentive. While the latter component is typically paid in share options, the others are paid in cash. Accounting research indicates that compensation mixes that are more weighted toward accounting-based pay are associated with higher future performance (Larcker, Richardson, & Tuna 2007). Managers' short-term cash bonus

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[1] See Pavlik et al. (1993) for an early review of executive compensation issues. Bodolica and Spraggon (2009) provide a more recent review of research on the link between executive compensation and mergers and acquisitions, while Fields, Lys and Vincent (2001) review research on accounting choice.

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constitutes accounting-based pay and may provide a larger incentive when making accounting decisions. We thus examine the relationship between a manager's short-term cash compensation and the amount of goodwill recognized in an acquisition. Based on Gordon's (1964) proposition, we expect that managers choose accounting procedures that maximize their own welfare. Managers whose compensation package depends heavily on cash bonuses would thus recognize more goodwill in order to avoid amortization charges and increase their company's earnings as well as their bonuses.

This reasoning suggests a linear relationship between bonus payments and the recognition of goodwill. However, Healy (1985) points out that managers do not always choose income increasing accounting policies to increase their variable compensation. Instead, he argues that below and above certain thresholds, changes in earnings do not matter for the determination of cash bonuses, which is why managers are not expected to choose accounting policies opportunistically outside a certain corridor. Adapting Healy's (1985) framework to the recognition of goodwill, we expect that bonus intensity is only to a certain extent an incentive to recognize more goodwill. Below and/or above certain thresholds, cash bonuses are not expected to influence goodwill recognition since managers do not expect additional gains from higher goodwill.

Mergers and acquisitions are worth studying from an accounting perspective since they are unique corporate events that often have a considerable impact on an acquirer's financial position and on the public's perception of the merging companies. We contribute to the literature by providing insights into the impact of compensation arrangements and accounting choice on the accounting for business combinations. While Shalev, Zhang, and Zhang (2011) examine executive compensation and goodwill recognition under US GAAP, ours is the first study to analyze these issues in an environment that is based on International Financial Reporting Standards (IFRS).

IFRS 3 *Business Combinations* provides in-depth guidance on how to account for mergers and acquisitions. However, the standard includes large areas of discretion, which foremost relate to the identification and valuation of intangible assets. For these assets, managers apply valuation techniques that are based mainly on level 3 inputs. Consequently, they obtain an advantage over other parties such as investors due to informational asymmetry (Landsman, 2007). Discretion regarding the valuation of assets and informational asymmetry culminates in the amount of goodwill the acquirer recognizes since goodwill remains as a residual after deducting the fair value of acquired net assets from the price paid for the target. Thus, discretionary valuation of intangible assets translates into discretion regarding the recognition of goodwill, which is an item that is all the more interesting to managers due to its exceptional accounting treatment. Since goodwill is not amortized but merely tested for impairment (at least) yearly, managers avoid otherwise necessary depreciation and amortization charges by recognizing more goodwill. Consequently, more goodwill would, ceteris paribus, result in higher net income. Managers may wish to make use of the flexibility regarding goodwill depending on their accounting policies. In addition, they may want to avoid amortization charges for their personal benefit given the importance of accounting earnings for determining executive compensation. Our paper examines whether or not CEOs tend to increase the amount of goodwill recognized in acquisitions if their pre-acquisition cash compensation depends largely on bonuses, possibly to further increase their remuneration.

We test our hypotheses by examining 123 mergers and acquisitions that were completed by Stoxx Europe 600 companies between 2005 and 2008. We find that the amount of goodwill recognized is heavily influenced by economic factors concerning the target company and expected synergies to be created by the merger. We also find that managers recognize more goodwill the more their compensation package depends on short-term bonuses. Examining bonus intensity more closely, we find that the relationship between cash bonus and goodwill applies for managers whose bonus element is between 150% and 200% of their base salaries. For CEOs whose bonuses are above 200% of their base salaries, we do not find a significant relationship between cash bonus and amount of goodwill recognized. In these cases, managers may choose to refrain from influencing the recognition of goodwill because they may not expect additional benefits from higher goodwill.

Further analysis shows that for CEOs whose bonuses were above 150% of their base salaries prior to the acquisition, bonuses increase in the year of the acquisition but decrease significantly in subsequent years. The initial increase in bonus may be interpreted as a reward to the CEO for conducting the acquisition. Based on our results, we recommend that companies introduce bonus caps, which are common features of compensation arrangements and which represent upper limits to the amount of bonus a manager can earn. If a bonus plan does not include such a cap, managers seem to choose income-increasing accounting policies and recognize more goodwill, increasing future impairment risk. Our results are in line with Arya, Glover, and Mittendorf (2007) who find that bonus caps help align shareholders' and managers' interests by making CEOs more risk-averse and more focused on longer-term objectives.

Other sub-sample analyses provide somewhat weaker evidence and suggest that CEOs' cash bonus is a determinant of goodwill recognition especially for non-financial companies and acquirers residing outside the United Kingdom. These results seem to be in line with prior research that finds an increased earnings management culture for countries in continental Europe (e.g. Lang, Smith Raedy, & Wilson, 2006; Leuz, Nanda, & Wysocki, 2003). Our research adds to this literature by suggesting that compensation concerns may be an additional reason for country differences regarding earnings management.

2. Theoretical framework

2.1. Agency theory, accounting choice and goodwill recognition

In a principal agent setting, accounting takes an essential role due to its stewardship function, which helps fulfill principals' demand for information to control agents' performance (Gjesdal, 1981). Absent perfect information on managers' behavior,