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Goodwill under IFRS: Relevance and disclosures in an unfavorable environment

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ABSTRACT

The accounting treatment of purchased goodwill under IFRS has been severely criticized due to the extensive use of fair value accounting. The purpose of this study is to enrich the ongoing debate upon this issue by drawing attention to the market valuation implications of goodwill in a country outside the Anglo-Saxon accounting paradigm, where the application of fair value accounting has been seen as more problematic. The results indicate that, in the case of purchased goodwill, fair value accounting generates relevant accounting numbers but only in companies that comply highly with IFRS disclosure requirements.

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1. Introduction

The controversial nature of purchased goodwill has been puzzling accounting practitioners and scholars for more than a century. Since the end of the nineteenth century, accountants have been struggling to find the most appropriate accounting treatment for the pecuniary difference between the consideration transferred for acquiring a business and the acquiree's value (Cooper, 2007). Miller (1973) commends on this issue:

> "*The term 'goodwill' is necessary for the accountant because he attempts to disaggregate the purchase price for an organized whole only by isolation of elements which are classifiable according to traditional accounting procedure and which can be valued arbitrarily in terms of some historic costs or external market values*" (Miller, 1973, p. 285).

Even though little has changed regarding the recognition criteria for goodwill since Miller's commentary, the recent adoption of International Financial Reporting Standards (IFRS) by more than 120 countries has reignited the controversy regarding the measurement of purchased goodwill due to the extensive use of fair value accounting (FVA). FVA is said to have desirable but also questionable attributes. On the one hand, fair value is considered a superior economic measure in comparison with historical cost, but on the other hand, it may lead to valuation failures, mainly in cases in which 'mark to model' estimations are employed (Ball, 2006; Franklin & Carletti, 2008; Penman, 2007). Goodwill accounting is heavily influenced by FVA both at goodwill's initial recognition and measurement under IFRS 3 as well as at its subsequent annual

Abbreviations: ASE, Athens Stock Exchange; FVA, fair value accounting; IFRS, International Financial Reporting Standards; OLS, ordinary least squares.

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impairment test under IAS 36. As a consequence, purchased goodwill is found in the center of the criticism for FVA (Ramanna, 2008; Sevin & Schroeder, 2005; Wines, Dagwell, & Windsor, 2007). For instance, Wines et al. (2007) criticize the new accounting treatment of goodwill as highly subjective and with potential negative implications for financial reporting. In addition, Beisland (2013) argues that if fair values for certain assets are not easily accessible, then it is very possible that companies' market valuation will be hindered (and not facilitated) by FVA. Similarly, Ball (2006) notes that in countries that depart from the economic and legal environment of the so-called Anglo-Saxon countries, there is a higher probability of problems with 'mark to model' estimates occurring due to these countries' unfavorable institutional environments and accounting traditions. In such settings, the relevance of accounting numbers influenced by FVA is questionable and worthy of examination.

Whether these concerns are valid remains an open empirical question, as there is no clear evidence of the market valuation implications of assets that are heavily influenced by FVA under IFRS, especially in unfavorable environments for the application of the new Standards. With regard to goodwill, its market valuation implications have mainly been examined in Anglo-Saxon accounting settings, where local accounting standards present many similarities to IFRS. However, there is no clear evidence concerning this issue in unfavorable (for the implementation of IFRS) environments. This study attempts to shed some light upon this empirical issue. Specifically, it examines the value relevance of purchased goodwill under IFRS in a number of companies listed on the Athens Stock Exchange (ASE). Greece can be classified as an unfavorable environment because it is a code-law Continental European country with a stakeholder-oriented and taxation-driven national accounting system (Ballas, Hevas, & Neal, 1998; Nobes, 2008). In addition, because Greece is a low-trust society, its accounting environment is highly formalistic; hence, the use of FVA is limited in favor of historical cost accounting. Thus, the consequences of the application of the new Standards, especially those that are heavily influenced by FVA, on the market valuation of accounting numbers are questionable.

Another important consequence of the highly formalistic accounting environment in Greece is the absence of extensive supplementary disclosure requirements. The local accounting standards do not leave much space for management discretion; thus, there is no need for mandating detailed disclosures. The mandatory implementation of IFRS by all listed companies in 2005, however, has vastly changed the reporting landscape. The new Standards leave much more space for management discretion (especially where FVA is applied); hence, there is a need for the justification of management decisions. This need is claimed to be covered by the mandating of voluminous disclosures by IFRS.

Despite the allegedly important role of mandatory disclosures, there is a lack of empirical studies on their valuation implications. This study corresponds to the calls for further research on the field of mandatory disclosures (Leuz & Wysocki, 2008; Schipper, 2007; Zéghal & Maaloul, 2011) by examining whether companies' decisions to comply to a greater or lesser extent with the IFRS disclosure requirements for goodwill bears any impact on the value relevance of their purchased goodwill.

Some European evidence shows that the value relevance of net income is significantly higher for companies that comply highly with IFRS disclosure requirements than for those that do not (Paananen, 2008; Tsalavoutas & Dionysiou, 2013). On the contrary, the same studies find that the value relevance of balance sheet items at an aggregated level (that is, the book value of shareholders' equity) does not differ between companies that comply with IFRS disclosure requirements to a greater extent and those that comply to a lesser extent.

Nevertheless, there are reasons to believe that the market valuation implications of specific balance sheet items that are heavily influenced by FVA might differ. The main reason is as follows. For accounting items heavily influenced by FVA, explanatory disclosures are of high importance because the accounting treatment of these items does not follow detailed rules but is strongly based on managerial decisions. These decisions are primarily related to assumptions, forecasts and projections about the future and need to be justified. The insufficient justification of the management's decisions may lead to accounting numbers of low reliability and therefore low value relevance. Otherwise, the extensive disclosure requirements of IFRS seem to have no impact on accounting items' valuation implications, allowing their usefulness to be questioned.

The present study attempts to enrich our understanding of mandatory disclosures focusing on IFRS disclosures for goodwill. Specifically, using two different approaches for measuring the level of compliance with IFRS mandatory disclosure requirements for goodwill, this study examines whether goodwill's value relevance differs between companies with relatively high and low levels of compliance.

The remainder of this study is structured as follows. The next section describes the Greek accounting environment and justifies why it can be characterized as unfavorable for the application of IFRS. Subsequently, prior studies are discussed to develop the tested hypotheses. The research design is then illustrated, and the company selection procedure is outlined. The data are described and the empirical analyses are presented in the next section. Finally, conclusions are drawn.

2. Implementing IFRS in an unfavorable environment

Greece is classified as a code-law Continental European country with a stakeholder-oriented and taxation-driven national accounting system (Ballas et al., 1998; Nobes, 2008, 2011). Similar to most Continental European domestic accounting standards, under Greek accounting standards, the use of FVA is limited in favor of historical cost accounting. Hence, it can be characterized as an unfavorable environment for the implementation of IFRS and the application of FVA in particular. Greece's domestic accounting standards are mainly influenced by the French accounting system and the European Union's legislation (namely, the Fourth and Seventh EU Directives), which differ substantially from IFRS (Ding, Hope, Jeanjean, &

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