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Relative reliability and the recognisable firm: Calculating goodwill impairment value

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ABSTRACT

This paper complements financial accounting research by a qualitative study of financial accounting practices. Its object is goodwill impairment tests (IAS 36) under the influence of International Financial Reporting Standards, which it uses to illustrate how financial accounting is produced. The aim is to investigate how accounting standards are translated into accounting practices, and to investigate how this is reliable. Drawing on actor network theory, the paper proposes calculative practices to be a networked and distributed affair. The study has two main contributions. Firstly, it shows that in the case of goodwill impairment tests, financial accounting is a process of finding, qualifying, stabilizing and calculating traces that often have to be found beyond the company infrastructure of sheets of accounts and the financial ledger. Secondly, it shows that these traces increase reliability when they are recognisable and impersonal. No single person is responsible for the financial calculation and the traces used assume that a firm cannot systematically outperform the broader economy or the history of the firm. It also helps to increase reliability if institutional roles such as auditors and valuation experts tolerate the calculation. Reliability increase when traces and supporting institutional actors that take part in the calculation are at a distance. Because of this production process, readers of financial statements face the following paradox: the things they see are less associated with specific entrepreneurial activities in the firm and more with normalised trends inside and outside the firm. Seeing the firm requires them to look at its past, at negotiated budgets, at its competitors, at industrial outlook, and at the statistical bureaus that compile information on the economic development of industries and countries; they may also have to listen to valuation experts and auditors. Seeing the value of a firm requires actors to look elsewhere.

1. Introduction

"That's the paradox. That's where we walk a very thin line. We communicate reality: that is the myth; that is what people believe. It is even what most of us believe. And, in a sense, we do communicate reality. There is something there: bricks and people and so on. And the organisation can, say, be 'doing well', or 'doing badly', in whatever sense you take that to mean. And it is our job to convey it. But what is 'the full picture'? There is no full picture. We make the picture. That is what gives us our power: *people think and act on the basis of that picture!* Do you see? Are you beginning to see?" (Hines, 1988, p, 265).

Ruth Hines' (1988) famous fable about financial accounting asks of us to contemplate what it is that we see when financial accounting communicates the world. We observe a construction and see less than a full picture, she says: "There is no full picture" (ibid., p. 265). So, which picture does financial accounting make us see? More specifically, when readers of financial statements observe a calculation of goodwill impairment based on net present value, what do they see? To answer this general question, it is necessary to study how financial accountants produce financial statements. While there is a discernible body of market-based research designed to test the effects of financial accounting choices, e.g. in relation to fair value accounting (Laux & Leuz, 2009), empirical research about the production of accounting is largely absent (Durocher & Gendron, 2011; Hopwood, 2000; Young, 2006).[1]

[1] There are important studies of auditing practices (for an early review of audit practices, see Power (2003), of auditing firms (Anderson-Gough, Grey, & Robson, 2001; Cooper, Greenwood, Hinings, & Brown, 1998; Gendron et al., 2007; Kornberger, Justesen, & Mouritsen, 2011; Suddaby, Cooper, & Greenwood, 2007), and of audit-committee practices (Gendron & Bédard, 2006; Gendron et al., 2004).

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This generally motivates the paper's interest in translations from financial standards into financial accounting practices, which are critical in order to understand what financial accounting makes visible (Robson & Young, 2009).

The paper has two main aims. Firstly, it seeks to explore translations between financial accounting standards and financial accounting practices. As a construction, financial accounting is often presented as easily mouldable because it is mathematical (Vollmer, 2003, 2007) and easy for managers to manipulate by changing the calculation to undertake earnings management (Macintosh, 2006, 2009; Ramanna, 2008). When understood as this type of construction, accounting is in the hands of the few who can design it to suit their interests. However, there may be a limit with regard to how far this can go because the more personal financial accounting is the less reliable it will be and then it will not engender trust and comfort (Pentland, 1993; Power, 1995, 1996, 1997, 2003). It is important therefore to investigate whether and how a financial accounting construction is different from a personal statement. The second aim is to explore what readers of financial statements see when financial standards are translated into practices. Accounting standards delimit the financial accounting object in principle, but they do not specify the empirical demarcations that locate the standard in practices of financial accounting (Lezaun, 2006). Financial accounting understands the economic world from the classifications produced by sheets of accounts and the general ledger. They organise transactions and records which are the remaining simple traces from complex economic selling, purchasing and production events. The records in financial accounting database are typically understood as traces of *past events*. However, International Financial Reporting Standards (IFRS) pose the challenge that financial accounting increasingly is tasked to engage with *the future*. Traces therefore have to be indications of the future and these traces may not intuitively be part of the set of historical records found in the financial accounting database. It is therefore not clear what it is readers of financial accounting can see when they observe financial accounting.

To achieve these aims, the paper investigates how goodwill impairment is produced. This is a critical case for IFRS because goodwill is a level three asset that requires being tested for impairment by means of models. It has no market value per se (Bougen & Young, 2012; Macintosh, Shearer, Thornton, & Welker, 2000). Goodwill is difficult for two reasons. First it is a residual value and has no associated discernible and separable asset; and second it is about the future. It is a critical incidence for IFRS. If goodwill accounting is reliable – in the sense of being able to be relied upon – this may also be so for other IFRS based valuations. Accordingly, the specific research questions are: how do financial accounting practices produce goodwill impairment value, and how is the financial accounting calculation reliable?

Drawing broadly on actor network theory (e.g. Latour, 1989, 1987, 2005), the study examines the practices of calculation as a distributed network.[2] According to this approach, the preparer is not a mind or brain that more or less liberally interprets accounting and changes it to suit individuals' interpretations and strategies. Instead, financial accountants are a part of a wider set of actors including both human actors and non-human actants who in their own ways influence the preparation of financial statements. Financial accountants may find themselves in a centre of calculation which is obligated to develop financial statements, but they cannot do this only by themselves. At least, as a centre of calculation, the financial accounting office requires records to calculate on. These records are typically traces of activity that has happened elsewhere in time and space. The financial accounting office cannot calculate if it does not have traces that enable it to translate the financial accounting standard. The financial accounting database is a "large star-shaped web of mediators" (Latour, 2005, p. 217) which allows things to flow into and out of the financial accounting office: traces flow in and financial statements flow out. As Latour (2005) says, any actor such as a financial accounting office is made to exist by many relations and entities. Therefore, the financial accounting office's efforts to develop financial statements are mediated by non-human actants (e.g. traces in the form of records) and human actors (e.g. auditors) that together negotiate what the financial statement is about. Through this approach the preparer is a network more than a single person or mind.

The empirical analysis is based on Finnish data. Finland is a critical case for analysing effects of IFRS on financial accounting practices because IFRS were a radical step for Finnish preparers (Nobes, 2013). Not only did the regulation change from a classical continental European conservative focus to an IFRS fair values approach almost overnight (Erb & Pelger, 2015; Power, 2010), it also made IFRS regulation to be Finnish regulation with no adaptation (Kettunen, 2014). No preparer could be expected to have expertise.[3] Drawing on interviews with 55 financial accountants, auditors, financial advisors, the financial supervisory authority, financial analysts, investors, creditors, media and practice-influencing academics with a focus on their experiences working with goodwill calculations.

The study has two main contributions. As a study of financial accounting in action, it shows firstly that as practice, preparers of financial statements are busy finding, qualifying, stabilizing and calculating traces typically found outside the financial accounting database. The study shows that the traces that are favoured by preparers construct a financial statement, which when observed by readers make them see away from the specifics of the firm.

Secondly, the urge to see away from the firm is an effect of preparers' understanding of reliability. It appears that traces produced by external statistical bureaus, external advisors and consultants are preferred to internal ones; internal traces that are negotiated such as budgets or used for several purposes are preferred to individual and singular ones. Individual traces proposed by entrepreneurial managers are not trusted. This matters because traces are then understood to represent an impersonal "view from nowhere" (Nagel, 1986; Porter, 1992, 1994b). The reliability of the accumulation of traces is helped by many people tolerating it; people who occupy institutionalised positions or roles such as auditors and experts are stronger than financial accountants and managers.

These characteristics make the calculation of goodwill impairment recognisable, realistic and un-surprising. This practice is not as much concerned with seeing the economics of the particular entrepreneurial activities of the firm as may be the ambition of IFRS (Barth, 2007). Instead, drawing on country and industry averages, on historical growth-rates, and on negotiated budgets, the calculation is more average to the firm and the economy than might be expected (see e.g. Ramanna & Watts, 2012). To some extent, the specific properties of the firm disappear from the calculation and what

[2] Prior research on goodwill accounting has addressed goodwill impairment testing using quantitative methods. This research suggests that impairment testing procedures help opportunistic management discretion in relation to the timing and magnitude of goodwill write-offs (Beatty & Weber, 2006; Massoud & Raiborn, 2003; Ramanna, 2008; Ramanna & Watts, 2012; Wines, Dagwell, & Windsor, 2007). New CEOs may use goodwill write-offs to clean the books (Masters-Stout, Costigan, & Lovata, 2008), and managers may engage in big bath earnings management and write goodwill off when earnings are already depressed (Jordan, Clark, & Vann, 2007).

[3] This makes Finland a critical case for the analysis of the implications of the change of accounting regulation. It is likely that the case of Finland will be a more systematic experiment of the effects of adoption of goodwill impairment testing than Anglo-Saxon countries (Mennicken & Millo, 2012; Nobes, 2013). A few Finnish firms already had a little exposure to goodwill accounting having applied US-GAAP.