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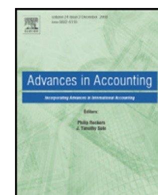

Overpaid acquisitions and goodwill impairment losses — Evidence from the US

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ABSTRACT

The purpose of this study is to shed light on the reliability of accounting goodwill numbers by examining whether many goodwill impairment losses arise from overpayment for the target at the time of the acquisition, rather than from a subsequent deterioration of goodwill values. A second related objective is to assess whether the goodwill impairment test introduced by SFAS 142 improved the ability of accounting standards to timely capture situations in which the amount of goodwill is overstated and should thus be written down.

For a sample of 929 US acquisitions first, I found that certain acquisition characteristics represent powerful indicators of subsequent goodwill impairments, suggesting that SFAS 141 is at least partially unable to avoid components other than "core goodwill" being included in goodwill. I also found that SFAS 142 annual impairment tests improved the timeliness of recognizing goodwill write-offs, eventually helping to mitigate the failure of SFAS 141.

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1. Introduction

Accounting rules on business combinations have dramatically changed during the last ten years, both in the US and in Europe as result of a common effort of the standard setters toward the international convergence of accounting rules. The new standards abolished the pooling of interest, introducing a single method to account for business combination transactions, the purchase method, and eliminated the amortization of goodwill after acquisition, instead requiring that goodwill be tested for impairment at least annually.

Under SFAS 141, goodwill arises at acquisition as a residual value when the amount paid to acquire a company is higher than the fair value of the identifiable net assets of such a company. The amount of goodwill is separately recorded as an asset in the acquiring company's balance sheet.

According to SFAS 141, goodwill values should embody essentially two elements (referred to as "core goodwill"): the fair value of the going concern of the target's business as well as the fair value of the synergies expected from combining the acquiring and target firms' businesses. Thus the statement claims for a careful assessment of goodwill values by the acquiring entity at the acquisition date, so that components other than core goodwill are minimized.

The main objective of this study is to shed light on the reliability[1] of accounting goodwill numbers by examining the causes of goodwill impairment losses. One way to accomplish this task is to determine whether goodwill impairment losses are predictable. More specifically, I hypothesized that the cause of many goodwill impairment losses is that the target firm was overpaid at the time of the original acquisition, as signaled by certain proxies for overpayment, rather than the subsequent occurrence of events leading to a performance deterioration of the reporting unit (or units) the acquired goodwill was allocated to. This understanding is essential for investors, financial statement users and standard setters as evidence that goodwill impairment losses can be predicted based on certain measures indicating overpayment at acquisition would signal that SFAS 141 is at least in part unable to avoid those components other than core goodwill being subsumed in goodwill.

Moreover, understanding whether goodwill numbers are reliable is especially important because of the magnitude of those numbers. In fact as a result of the above depicted changes in the reporting regime, the amounts of goodwill recorded in the financial statements of many corporations have risen considerably.[2]

A second related objective of my analysis is to test whether the requirement for annual impairment tests of goodwill imposed by SFAS 142 improved the ability of accounting standards to timely detect situations in which the amount of goodwill should be written down, helping to mitigate the above described failure of SFAS 141.

I tested these hypotheses for a sample of 929 acquisitions made by US public traded companies over the nine-year period from 1999 to 2007. I tracked those acquisitions forward from the transaction date to September 2009 in order to detect goodwill impairment losses, if

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[1] Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information* par. 77–80.

[2] Hayn and Hughes (2006) highlighted that the mean value of goodwill to total assets for all firms included in the Compustat database increased from a 10.8% in 1988 to a 16.8% in 2001.

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any. I then examined whether the occurrence of the observed goodwill impairment losses could have been predicted based on the overpayment indicators measured at the acquisition date that I included in the model.

First I found that approximately a 40% of subsequent goodwill impairment losses were predictable based on overpayment indicators at acquisition, suggesting that in those instances the amount of goodwill was overstated at inception. Among the overpayment indicators included in my model only the percentage of the purchase price paid for with stock of the acquiring firm, the amount of goodwill in relation to the purchase price and the excess of purchase price over the book value of assets of the target firm are significant measures, whereas other variables have no explanatory power. In particular, the percentage of stock in the consideration is the most significant predictor and has a strong and positive association with the probability of an impairment loss, signaling that acquisitions paid for predominantly with the acquiring firm stock are more likely to result in a goodwill impairment loss after acquisition than are cash acquisition. This result suggests that managers are likely more prone to overpay for the target in stock acquisitions as probably they are more sensitive to potential losses of cash in cash acquisitions rather than to the dilutive effect of stock.

The amount of the purchase price assigned to goodwill is also strongly and positively related to the impairment loss event. That is, the likelihood of having an impairment loss increases the higher the amount of goodwill on the acquisition price. This result points out that when the percentage of the acquisition price assigned to goodwill is significant, the value of goodwill is more likely to include elements different from the synergies expected from the combination and the going-concern value of the target firm, and thus it is unlikely to offer a faithful and realistic representation of the underlying economics.

In addition, my analysis confirms that SFAS 142 was probably necessary. I found that the average time lag between the acquisition date and the recognition of an impairment loss ranges from 2 to 3 years. Results of an earlier study[3] showed that, before the enactment of SFAS 142, the average time lag between the acquisition and the recognition of a subsequent impairment loss was four to five years, indicating that goodwill was more likely to be kept untouched on the books after its economic deterioration. Therefore, my findings show that the application of SFAS 142 improved the ability of accounting standards to more timely detect situations in which the amount of goodwill should be written down, substantiating the hypothesis that SFAS 142 eventually helps to mitigate the failure of SFAS 141 described above.

This study contributes to extant accounting literature in several respects. First, it sheds some light on the reliability of accounting goodwill numbers providing evidence that certain indicators of overpayment can affect or predict the occurrence of a subsequent impairment loss when an acquisition is consummated. This result is particularly relevant for auditors, investors and other financial statement users as it helps to identify factors that should be considered in evaluating the management determination regarding the purchase price paid and the value of goodwill recognized at acquisition. Furthermore, this study corroborates the results of prior research on goodwill impairment prediction and gives additional indications stemming from the analysis of the post-SFAS 141 period. While previous research on predicting goodwill write offs focused on the analysis either of write-offs occurred during the 2002–2003 transition year, or of write-offs occurred even before, there is no study analyzing acquisitions and subsequent goodwill impairments occurred during the eight-year period to date after the issue of SFAS 141 and SFAS 142.

Finally, my findings provide empirical evidence in support of SFAS 142 requirements for the annual impairment test of the acquired goodwill showing that it have in fact improved the timeliness of recognizing goodwill impairment losses.

[3] Hayn and Hughes (2006).

The remainder of the study is organized as follows. Section 2 describes the accounting standards for business combinations and goodwill. Section 3 details the research issues related to prior literature. Section 4 explains the research method and the sample selection. Section 5 provides the empirical results. Section 6 concludes the study.

2. SFAS 141 and SFAS 142

For more than thirty years business combinations and goodwill in the US had been accounted for according to the provisions of Accounting Principles Board Opinion (APB) No.16, *Business Combinations* and Accounting Principles Board Opinion No.17, *Intangible Assets*. As a result of the common effort by the FASB and the IASB toward the international convergence of accounting standards, the FASB issued SFAS 141 and SFAS 142 in 2001, and SFAS 141R in 2007, which superseded the provisions of previous standards.

SFAS 141 and SFAS 142 modified in essence accounting for mergers and acquisitions requiring all business combinations initiated after June 30, 2001 to be accounted for using one method of accounting, the purchase method,[4] and abolishing goodwill amortization in favor of the annual impairment test of the acquired goodwill.

According with SFAS 141, the application of the purchase method[5] gives rise to goodwill if the cost exceeds the fair value of the net assets acquired.[6] As of the acquisition date, in order to test goodwill for impairment an entity is required to assign *all* goodwill acquired in a business combination to one or more reporting units.[7]

SFAS 141 maintains that goodwill acquired in a business combination is an asset, whose value includes six components[8]: the first is the excess of the fair values over the book values of the assets acquired and liabilities assumed in the acquired entity as of the date of the acquisition; the second component includes the fair values of assets and liabilities not previously recognized in the acquiree financial statements; the third component represents the fair value of the going-concern element of the acquired firm business[9]; the fourth element is unique to each specific combination as it embodies the fair value of the synergies and other benefits expected from combining the acquirer's and acquiree's net assets and businesses; the fifth component of goodwill is the value of measurement errors made by the acquiring firm in valuing the target firm, resulting in an overvaluation of the consideration paid for the target; finally, the sixth element is the overpayment (or underpayment) by the acquirer, which might arise from auction-like situation, when one or more bidders are competing for the target (overpayment), or from distress or fire sales (underpayment).

The value of goodwill – which the FASB refers to as core goodwill – acquired in a business combination should be represented only by the third and fourth component, as the other four elements do not meet the definition of asset.[10] For this reason, the FASB claims, SFAS 141 provisions are specifically designed to avoid subsuming in the value of goodwill recognized at acquisition components that are not part of core goodwill.[11] Moreover, including in goodwill elements other than

[4] Even though SFAS 141(R) carries forward the fundamental provisions of SFAS 141 about identification of the acquirer and the application of one method of accounting for all business combination, some aspects related to the application of the purchase method of accounting have been modified (i.e. scope of the statement; method of accounting for business combination, which is no longer called “purchase method” but is rather referred to as “acquisition method”; provisions on step acquisitions, on assets and liabilities arising from contingencies, and on contingent consideration).

[5] SFAS 141, Paragraphs 37–42.

[6] SFAS 141, Paragraph 43.

[7] SFAS 142, Paragraph 34.

[8] SFAS 141, Appendix B, Paragraph B 102.

[9] An entity's “going concern” element is defined as “the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately” (SFAS 141, Appendix B, Paragraph B 102).

[10] SFAS 141, Appendix B, Paragraph 103–105.

[11] SFAS 141, Appendix B, Paragraph 106.

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