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**Goodwill Accounting - An Examination of its  
Impacts on Mergers and Aquisition Decisions**

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## **ABSTRACT**

Over the past years, the FASB and the IASB have made sweeping changes in the accounting for goodwill and other intangible assets. In 2001 the FASB issued SFAS 141, “Business Combinations” and SFAS 142, ‘Goodwill and other Intangible Assets’. Concurrently, the IASB issued IFRS 3 “Business Combinations” and IAS 36 “Impairment of Assets” in 2004. IFRS 3 like SFAS 141 prohibited the pooling of interest method for the purchase method of accounting to record acquisitions. IAS 36 had the same resolution like SFAS 142, eliminating the amortization method and endorsing an impairment testing approach. These pronouncements are having a dramatic impact on financial statement information relating to M&A and their related goodwill. The purpose of this study is to find out if and how the new goodwill accounting treatment will affect M&A decisions in some selected Swedish companies. To meet this objective, an in-depth study was carried out with interviews conducted with some personnel of the companies. The result shows that, beyond the traditional reasons for M&A, these new rules will certainly affect some companies M&A decisions. The argument here largely depends on the goodwill amount on the statement of financial position and its effects on EPS.

Key words: FASB, IASB, SFAS 141, SFAS 142, IAS 36, IFRS 3, M&A, EPS

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## ABBREVIATIONS

APB	Accounting Principles Board
ASB	Accounting Standards Board
CGU	Cash Generating Units
ED	Exposure Draft
EPS	Earnings per Share
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GBV	Carrying Amount of Goodwill
GFV	Implied Fair Value
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
INA	Identifiable Net Assets
M&A	Mergers and Acquisition
SFAS	Statement of Financial Accounting Standards
UBV	Units Book Value
UFV	Fair Value of the Reporting Units
USA	United States of America

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# **Chapter 1**

## **Introduction**

*This chapter is to enable the reader have a quick understanding of the first part of our work. In this chapter, we present the background of the thesis where we discuss the different Accounting rules on Goodwill both in the US and Europe while looking at the effects of these rules on financial statements. Next, we discuss the problem followed by the presentation of the purpose of the thesis. We also present the scope and limitations of the thesis. The remainder of our work is presented in the thesis outline so that the reader can see the structure for a better follow up.*

### **1.1 Background**

The accounting treatment of goodwill has been the subject of heated debate in many countries throughout the world. However, it is worth noting that the numerous efforts by various professional accounting bodies through the issuance of exposure drafts and the promulgation of accounting standards, has resulted to a near agreement on the accounting rule for goodwill.

Until 2001 in the US and 2004 in Europe, companies accounted for business combinations using both the purchase method and the pooling of interest method in which no goodwill was recorded. On June 29, 2001, the Financial Accounting Standards Board (FASB) proposed sweeping changes in accounting for intangible assets and business combinations, with the issuance of Statement of Financial Accounting Standards (SFAS) N° 141, “Business Combinations” and SFAS N° 142, “Goodwill and other Intangible Assets. SFAS 141 stipulated all acquisitions carried out after July 2001 be accounted for by purchase method, thereby eliminating the pooling of interest method. SFAS 142 changed the accounting for goodwill from an amortization method to an impairment testing approach (Massoud and Raiborn, 2003).

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On March 31, 2004, almost three years later, the International Accounting Standards Board, (IASB) promulgated IFRS 3, “Business Combinations,” and IAS 36, “Impairment of Assets”. IFRS 3 like SFAS 141 prohibited the pooling of interest method and permitted only the purchase method of accounting to record acquisitions. IAS 36 had the same resolution like SFAS 142, eliminating the amortization method and endorsing an impairment testing approach (Esptein and Mirza, 2005).

Due to numerous dissatisfactions among financial statement users on the accounting treatment of goodwill, there was need to review these accounting rules. Some of these dissatisfactions include the non consideration of goodwill amortization as being useful in analyzing investments. Analysts equally noted that intangible assets are an increasingly important economic resource for entities and an increasing proportion of assets acquired in many transactions. This led the FASB to the conclusion that amortization of goodwill was not consistent with the concept of representational faithfulness and that non amortization of goodwill coupled with impairment testing is consistent with that concept (FASB, Homepage).

As a result of this transition, and with the possibility of huge write-offs of goodwill due to the impairment testing approach, the effects on the financial statements could be immense. Several studies have been carried out and as pointed by Huefner and Largay (2004), some of these effects are:

Large increases in net income (earnings) will be produced due to the elimination of goodwill amortization as an expense. For instance, in the USA where these rules were first promulgated, the annual profits of about 100 companies increased by approximately 20 to 25 billion dollars.

Another visible example was on January 7, 2002, where AOL Time Warner announced it expected to take a goodwill write-off of up to \$60 billion (almost half the amount recorded pursuant to the merger). However in Europe, no such implications are visible yet given that the new treatment of goodwill went into effect early this year.

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Eliminating amortization raises net income and tax increases without any corresponding increase in operating cash flow. Moreover, lower assets and equity balances resulting from write-offs of goodwill will increase debt ratios such as total liabilities/total assets and debt/equity creating unfavourable signals which can affect share prices. Furthermore this new goodwill accounting treatment also has a major implication on financial statement users as it creates discontinuity in data series creating difficulties for users of financial statements in estimating trends and forecasting future performance.

These effects will certainly trigger or undermine any potential M&A decisions. Cognizance of the fact that most large companies have attained their present size mainly through mergers and acquisitions and knowing fully well that in most of these acquisitions, goodwill amounted to 75% or more of the total price paid (Huefner and Largay, 2004). Our challenge is to investigate the impact of the new accounting of goodwill on M&A decisions. This gap is what we aim to fill with the present thesis by carrying out a study on some Swedish companies.

## **1.2 Problem**

Given the ever growing nature of companies, and the complexity that surrounds their accounting, credibility need to be gained and trust restored. As a result of this, financial statements need to reflect a true picture of the transactions carried out. In previous years, companies accounted for business combinations such that it was favourable to them and in some cases creating financial statement biasness and representational unfaithfulness. To remedy this and restore confidence to financial statement users, the FASB through SFAS 141 and SFAS 142 concurrent to IAS 3 and

IAS 36 requires companies to account for all business combinations using the purchase method with an annual impairment testing of the assets.

Without any fear or contradiction, we think this new rule will not be embraced in Europe without difficulties and consequences given that in the US where earlier applications had been observed, it was marked with several consequences. Despite this new rule, and the effects and difficulties

that might surround its application, M&A decisions could be given a second thought or continue to grow with even bigger deals. This thus brings us to the main research problem which is that of investigating the effects of the new goodwill accounting rules on M&A decisions. In order to throw more light on this research problem, we have formulated some specific questions

- How reliable is the value attributed to goodwill?
- What are the implications on the financial statements following the write-off of goodwill?

### **1.3 Purpose**

The purpose of this study is to find out if the new goodwill accounting treatment will affect M&A decisions in some selected Swedish companies. Considering the fact that, companies M&A decisions might be significantly influenced by the effects the new goodwill accounting rules may have on the financial statements, we would be obliged to look at the implications on the financial statements following the write-off of goodwill. Prior to meeting this objective, we find it necessary to look into the reliability of the value attributed to goodwill in the companies concerned. To ensure credibility, the impairment testing approach for goodwill valuation is also examined.

### **1.4 Scope and Limitation**

#### **1.4.1 Contribution of the Thesis**

This thesis joins a series of studies on the effects of the new goodwill accounting rules. However, our thesis is quite unique in that, we try to find out if these rules will affect M&A decisions. This study will undoubtedly be beneficial to companies, most of whom have so far focus on the traditional reasons for M&A. For example, economies of scale and development of synergies. In today's knowledge based economy, intangible assets particularly goodwill constitute a

substantial proportion of companies' assets and should therefore play an important role in a company's M&A decisions. Companies will therefore become aware of the fact that the consequences of acquired goodwill should be thought of before going into future acquisition. Previously, some companies never bothered paying too much for an acquisition given that goodwill constituted a significant proportion of the total cost and was amortized over a period of 40 years. Today, with the new rule, goodwill purchased in an acquisition could be written off after a few months. So this thesis will certainly serve as an eye opener to most companies.

Furthermore, this thesis will also be useful to other researchers interested in this area of study. Notwithstanding, we think the study of this new rule will also be beneficial to other stakeholders who might have lost confidence in financial statements.

### **1.4.2 Limitations**

When undertaking a work of this magnitude there is always some limitations that go with it. The thesis concentrates on Swedish companies. However, we were able to have interviews only with three companies. We would have loved to include more companies in the study. Goodwill is an item that is very much important with service industries like banks and insurances companies, but we were not able to have a hold on any service industry. Moreover time factor was also a problem as we would have loved to interview more companies.

## **1.5 Thesis outline**

The remainder of this thesis is divided into three parts.

The first part consists of two chapters; an introductory chapter and a research design or methodology chapter. The former was intended to acquaint the reader with the research problem and objectives at hand, and the latter which will be discussed below is devoted to providing an in-depth explanation of the research methods used in the study.

Part two is devoted solely to the theoretical framework chapter. This chapter is aimed at informing the reader about major issues relating to the research area under investigation.

Part three consists of four chapters; in the first one, we present the findings of the study. Closely followed is the analysis chapter in which we tie together our empirical findings with the theory. In the conclusions, we will try to give an answer to the research problem and suggestions for further research in areas related to the thesis subject will be made.

Finally, we will consecrate the last chapter to the list of literature, articles, internet sites and interview guides.

## **Chapter 2**

### **Methodology**

*In this chapter, we begin by outlining some of the concepts of methodology applied in the thesis. An in depth explanation of the different methods used will be presented and reasons will be given as to why we choose a particular method. This will be done by comparing the different methods.*

#### **2.1 Scientific Approach**

According to Perry 1998, deductive theory testing and inductive theory buildings are the two major approaches to theory development. The difference between them is mostly concerned with the sequence in which they occur during the research activity, Johns and Lee-Ross (1998).

The deductive approach represents the positivist paradigm. Here, the researcher uses prior theory to base data and facts. He puts forward a hypothesis, which is then tested by experiment to see whether it is supported by practical experience. Thus, the observation stage of the process comes after the formulation of the hypothesis. The inductive approach represents the phenomenological paradigm. Here, the researcher finds a field of interest, after careful observations have been made. The data are examined and analyzed enabling theory generation. This model of science is called inductive reasoning because the facts induce the conclusion, Johns and Lee-Ross (1998).

The thesis is written using both the inductive and deductive approach. This is because they both provide potential to readily analyze and generalize our findings. This is in line with the ideas of Perry 1998 who says it is impossible to separate the two approaches of induction and deduction and Richard 1993, p.40 says "both prior theory and theory emerging from the data are always involved ,often simultaneously.



The purpose of our study is to understand and interpret a phenomenon. This will be done by gaining understanding of the new accounting rule on goodwill and our ability to interpret and generalize our findings on how this new rule will affect M&A decisions. Thus, we have to acknowledge the fact that, even though, our findings might enable us develop theories, we cannot do this without making reference to past literature and theories as this provides focus to the data collection phase. This enabled us in formulating our interview questions.

## **2.2 Research Method**

When conducting a scientific research, we can either use the quantitative or qualitative method. The aim of a quantitative study is to determine the relationship between one thing (independent variable) and another (dependent variable). Qualitative research on its part aims to find out the characteristics of a research sample, in terms of behaviours, perceptions, values and attitudes (Johns and Lee-Ross, 1998).

In this thesis, we will use the qualitative method as we try to find out the companies perceptions on M&A decisions relative to the new goodwill rules. We opted for interviews as we believe this is the best way to collect primary data. We preferred this method to other methods like questionnaires because; an interview gives us the possibility to follow through the question session. The respondent is asked to make clarifications when his/her views are not clear enough. Moreover we think the face to face contact with the respondent enhances the interview process.

In this study, we carry out four interviews in three companies. The choices of these companies are explained in the latter part of the thesis. We perform all the interviews at the premises of the companies in question. We opt to use a tape recorder in the process as not to miss any detail of the interview. By this, we make sure the views of the respondents are not misinterpreted. Finally, we then transcribe the data.

## **2.3 Research Approach**

The choice of research approach depends heavily on the research topic in question. You may be interested in doing a case study on some topics, in others an experiment, a survey or a history. These and other choices represent different research strategies. Each being a different way of collecting and analyzing empirical evidence following its own logic (Yin, 1994).

As explained in chapter one of this thesis, we aim to find out the impact of the new goodwill accounting on M&A decisions. For a better appraisal of the situation, we decided to carry out an in-depth study on some selected Swedish companies. According to Yin (1994), there exists two main research approaches, exploratory and descriptive.

### *Exploratory*

The purpose of this kind of study is to collect as much information about a certain problem area as possible. The problem is thus analyzed from a number of different points of view. Such a study often provides the basis for further research.

### *Descriptive*

A descriptive study involves a detailed look at the fundamental aspects of a phenomenon. With such a study, essential aspects of the concepts under investigation are looked into.

This thesis will use the exploratory and descriptive approach as they best suit our work. The descriptive approach will be used in the theoretical framework as we try to explain the main concepts of the thesis (goodwill accounting rule, mergers and acquisitions). The exploratory method will be used during the empirical findings. We will then explore the companies under investigation compliance with the new goodwill accounting rules and if it will affect their M&A decisions. This will be achieved by means of an interview. The analysis thereafter will enable us to conclude and make suggestions for future research.

## **2.4 Data Collection**

Collecting data for a research is of uttermost importance as this will undoubtedly affect the research outcome.

Case study methodology is defined as a research methodology based on interviews. The methodology usually investigates a contemporary phenomenon within its real life context when the boundaries between phenomenon and context are not clearly evident (Perry, 1998). Yin (1994) proposes some guides on collecting data in case studies (question asking, listening, adaptive ness and flexibility, grasp of the issue being studied and lack of bias) which we have tried to comply with.

There exist two types of data, primary data and secondary data. Primary data is information that is collected for the first time. The only disadvantage with this type of information is that it can be costly to collect. Secondary data is information that exists already in books, articles and electronic sources. Secondary data can be divided into internal and external data. Internal data is information gotten from the company and external data is collected from books, articles, magazines available to the public.

We conduct some interviews given that it is our primary source of data. At this stage, we also use internal secondary data from the companies being interviewed. This will enable us understand the impact of the new goodwill accounting on M&A decisions of these selected Swedish companies. To achieve this, the interviews are structured and questions are predetermined and the order of the questions is determined in advance. A partly structured and unstructured interview will be inappropriate. This is due to the fact that certain issues need to be covered by all respondents. An unstructured interview would be unsuitable due to difficulties associated with analyzing data though it is often richer in data (Johnson and Gill 1991).

External secondary data will be collected from articles, past thesis, internet and books. Most of the articles we will use are peer reviewed. This will help us develop theories which will serve in subsequent interpretation of our findings.

## **2.5 Quality of Research**

The concept of validity and reliability are frequently used when the scientific value of reports are being discussed. Yin (1994) however proposes four tests used to establish the quality of empirical social research; construct validity, internal validity, external validity and reliability.

### *Construct validity*

By this, we mean establishing correct operational measures for the concepts being studied. This is especially problematic in case studies as people often point to the fact that, the investigator fails to develop a sufficiently operational set of measures. Moreover, they use subjective judgments while collecting data. As a remedy, we had our draft findings reviewed by key informants before publication.

### *Internal validity*

Internal validity handles the question whether the research authors measure what is supposed to be measured. It is concerned with explanatory studies only and not for descriptive or exploratory studies.

### *External validity*

This establishes the domain to which a study's findings can be generalized. It deals with the problem of knowing whether a study's findings are generalizable beyond the immediate case study. In the simplest example, if a study on 'Goodwill Accounting; its impact on M&A decisions' focused on company A, will the result of this study be applicable to other companies. To cope with this situation we decided to work with three companies from different industries, this we believe will serve as basis for generalization.

### *Reliability*

The objective here is to ascertain if a later researcher followed exactly the same case study he should arrive at the same findings and conclusion. The emphasis is on doing the entire study all over again and not on replicating the results of a study by doing another. In this thesis, we think

the sources used are reliable. Articles, books and other sources of information are questioned and valued from our knowledge base concerning who wrote them and for whom it was written. Moreover, the answers by our respondents are weighed together with our knowledge of the company and our ambition has been to handle the information with objectivity. Furthermore, all the respondents we interviewed are professionals in the field with a lot of experience. They have been working with this area for at least three years.

## **2.6 Sample**

We gathered information from a wide range of sources which include the internet, books, articles and interviews.

To build our theoretical framework, we read some books and articles with searches on the internet. This was to enhance our understanding of the main concepts; goodwill accounting and M&A. We used the internet to have a quick overview of the different companies.

For the empirical research, we focused on interviewing the different heads of group accounting of the selected companies and some personnel of their respective M&A departments.

It should be noted that our choices of the companies were motivated by different reasons. At Volvo AB, we contacted Mikael Hagström who is head of group accounting for Volvo. This decision was because of our desire to understand the implementation process of IFRS 3 in Volvo AB and he perfectly suited that. Due to his tight schedule we finally had the interview with Annica Gustavsson who is a controller at Volvo's group accounting. Still at Volvo, we interviewed Gilberg Ulf of the M&A department based on a recommendation by Mikael Hagström. Our motivation for Volvo was again driven by the huge acquisition of Renault trucks in 2002. We wanted to find out if and how this new rule will affect their financial statements and possibly their future M&A decisions.

We also interviewed the head of group accounting of a major Swedish company who because of confidentiality reasons ask us not to disclose his identity. Thus, we denote him Mr X and his

company Y. Our reason for selecting this company is as follows; since 2001, Company Y has been involved in 12 different acquisitions. Therefore, they have experienced a lot of goodwill in the acquisition processes.

Lastly, we interviewed Johanna Tesdorp who works with goodwill impairment and M&A decisions at Atlas Copco. Our choice of this company was governed by their huge goodwill balances. This contact was given to us by Annica Gustavsson. Our choice of this company was due to a couple of reasons. Atlas Copco had a very controversial amortisation plan. They allocated different number of years to different acquisitions, ranging from 10 to 40 years. Following the elimination of amortisation of assets by the IASB, the effects were substantial on Atlas Copco. Moreover, following implementation of rules on impairment of assets in 2002, Atlas Copco made a write-off of about SEK 7 billion. Thus we intend to find out if this rule will affect their M&A decision.

## **2.7 Criticism of Sources**

It is important to underscore the fact that information sources used in any work could be subject to criticisms. This can jeopardize its reliability and especially the relevance of the study.

We think the sources used in the thesis are reliable. In the theoretical framework, an extensive amount of literature and books are used. This is because we wanted to do a good analysis by comparing opinions of different authors thereby eliminating subjectivity.

In the empirical chapter where the result of our findings is presented, we think the information is of high credibility since the respondents were well informed and experts in their field. To buttress this, we sent a copy of the analysis of the responses for them to proofread for insertion in our work.

## **Chapter 3**

### **Theoretical Framework**

*This section of our work is divided into three parts. In part I, we give a vivid description of some accounting concepts relating to our thesis topic. First we take an in-depth look into the concept of Goodwill. The goodwill accounting methods and the valuation of goodwill is also looked into. Part I ends with a description of the concept of M&As. An in-depth understanding of these concepts is important as it serves as a basis for the empirical research and analysis of our results.*

*In part two, we look at the Goodwill Accounting Rules according to FASB and IASB. Differences between the two set of rules are also brought out clearly. Finally part three gives a brief overview of our chosen companies, their compliance with the goodwill accounting standards. A picture of the situation in Sweden is also portrayed.*

#### **3.1 Goodwill - The Concept**

Goodwill has been an extremely debatable topic for accountants and other stakeholders for nearly 100 years. The accounting treatment of goodwill has run from charging it to equity, to capitalizing it permanently, to amortizing it to earnings, retained earnings or additional paid in capital, and now to testing it for periodic impairment. At times, even capitalizing internally generated goodwill has been allowed (Davis, 2005).

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Goodwill is recorded only when an entire business is purchased, because goodwill is a “going concern” valuation can only be separated from the business as a whole. To record goodwill, the fair market value of the net tangible and identifiable intangible assets is compared with the purchase price of the acquired business. The difference is considered goodwill. **Goodwill is the residual: the excess of cost over fair value of the identifiable net assets acquired** (Kieso et al., 2001).

Internally generated goodwill can emerge from a company’s clientele, advertising and reputation, its trained employees and management team, its favorable business location, and any other unique features of the company that cannot be associated with a specific asset. Because goodwill cannot be separated from a company, it is not possible for a buyer to acquire it without also acquiring the whole company or a substantial portion of it (Spiceland et al., 2001).

However, a company must expense all such costs incurred in the internally generation of goodwill. Imagine how difficult it would be to associate these expenditures with any objectives measure of goodwill. For this reason, it is difficult to compare two companies when one has purchased goodwill and the other has not (Spiceland et al., 2001).

Goodwill generated internally is not capitalized in the accounts. Measuring the components of goodwill is simply too complex and associating costs with future benefits too difficult. The future benefit of goodwill may have no relationship to the cost incurred in the development of that goodwill, for example, staffs became more experienced as the years go by. To add to the ambiguity, goodwill may even exist in the absence of specific costs to develop it. In addition, because no objective transaction with outside parties has taken place, a great deal of subjectivity – even misrepresentation – might be involved (Kieso et al., 2001).



### **3.1.2 Goodwill Accounting Methods**

The accounting for goodwill has been a very controversial issue. In fact academics and researchers have discussed it since the 1890s (Seetharaman et al., 1999). Various professional accounting bodies with the likes of ASB, APB prescribed different treatment for goodwill. Among the various approaches, three could be discernible;

*Retention of the cost of an asset with amortization required over its estimated life.*

Proponents of this method claimed that goodwill is an asset representing the value of future economic benefits; it will thus be used up as other resources of the company, hence it should be amortized. Arguments against amortization were that any period of amortization is arbitrary. Selection of arbitrary periods of amortization can lead to understatement of net income during the period and an overstatement later.

*Retention of the cost as an asset indefinitely unless a reduction in value is evident.*

The argument in favor of retaining goodwill as an asset is that, its book value should not be reduced as the value of the asset appears unlikely to fall below cost. Critics however suggest acquired goodwill is deemed eventually to be replaced with self generated goodwill.

*The deduction of cost from shareholders' equity at the date of acquisition.*

Advocates of this method suggested that as the nature of goodwill differs from other assets, it should not be shown as an asset.

However the controversy is fading away as it seems to be a near agreement on the accounting for goodwill. Today only one accounting treatment of goodwill is permitted by FASB and IASB. This is laid out clearly in SFAS 141 and IFRS 3 of FASB and IASB respectively (Dogra, 2005). Companies have to recognize goodwill as an asset, test it for impairment annually and any loss in the value of the asset is written off via the profit and loss account.

### **3.1.3 Valuation of Goodwill**

The FASB and the IASB both stipulate an impairment review for goodwill valuation. Goodwill impairment can be reasonably valued using an appropriate application of any one of the four methods discussed below (Becker et al., 2002).

#### *Market Capitalization Method*

The company's market capitalization is added to the company's liabilities to arrive at its enterprise value. The value of all tangible and other intangible assets is then subtracted from the enterprise value to compute the worldwide value of goodwill.

This method of goodwill valuation is the most criticized among all the methods. Critics say it is too difficult to separate out the values of the various types of intangibles. Moreover, the market capitalization of a firm includes current and expected future intangibles, while the firm's value will only include current intangibles. However the market capitalization is theoretically sound and these criticisms are generally unfounded (Becker et al., 2002).

#### *Declining Royalty Approach*

This method is commonly used in the related party buy-in/cost sharing context. The royalties generated/paid is used as a proxy for value. It assumes that without continued development, intangibles lose value over time. In essence, the approach determines the market price (royalty rate) for goodwill throughout its useful life. It theoretically determines the royalty payment during any specific year of the intangible useful life in the following three steps:

Defining the market royalty rate for the intangible based on benchmarks, profitability or some other measure; estimating for each year of the intangible's useful life in the future, the portion of the intangibles value in that year that has already been developed and multiplying the value computed in the two previous steps to determine declining royalty rates for each year remaining in the intangible's useful life.

#### *Discounted Cash Flow Method*

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This is the most commonly used and taught methodology. It is quite common in valuing entire businesses and in valuing goodwill in M&As. It simply gives the present value on the future expected cash flows using a discount rate. The process is very direct for valuing businesses but some controversy surrounds the validity of projections as well as the appropriate discount rate. In applying the discount cash flow to goodwill valuation, one does not determine the total cash flows of the company or investment, rather it is the incremental cash generated by goodwill. The difference in the company's cash flow with and without the use of its goodwill defines the cash flows that would be discounted in goodwill valuation.

#### *Benchmark Comparisons*

This method looks at acquisition studies and publicly available metrics that, determine the ratio of intangible value to market value for similar companies. If acquired companies are functionally similar to the company that is being valued, their ratios of goodwill/total value and intangibles/total value may serve as broad benchmarks in goodwill valuation. These estimates are also perceived by investors to be trustworthy indicators of value.

### **3.1.4 Fair Value Accounting**

Fair value may be defined as the price at which an asset or liability could be exchanged in a current transaction between knowledgeable unrelated willing parties when neither is acting under compulsion (Epstein & Mirza, 2005). The FASB and the IASB recently adopted a fair value approach to financial reporting. This was met with a lot of resistance as lots of controversy surrounds fair value measurement.

According to Sayther (2004), fair value accounting clearly creates the potential for intentional and unintentional bias. The Enron case is a glaring example of intentional bias.

Sayther (2004, p. 6) says

.... "The beginning of the end for Enron was its ability to manipulate fair value calculations to its advantage recording revenue on transactions

that would not be profitable for several years out”.

Moreover, fair value models require lots of assumptions and every assumption a company makes is subject to second guessing by auditors, regulators and the press. Proponents of fair value accounting however claim with the passage of time historical cost becomes irrelevant in assessing present liquidity (Khurana and Myung, 2003), as such the need for fair value in financial reporting.

### **3.1.5 Mergers and Acquisition**

Epstein and Mirza (2005) define Mergers as a situation which exists when one enterprise acquires all of the net assets of one or more other enterprises through an exchange of stock, payment of cash or other property or the issuance of debt instruments. The preferred method of accounting here is the pooling of interest method .An acquisition is a business combination in which one entity (the acquirer) obtains control over the net assets and operations of another (the acquiree) in exchange for the transfer of assets, incurrence of liability or issuance of equity. The preferred method is the purchase method.

It is important to note that M&A have become increasingly popular in business practices and this is justified by the fact that many companies have attained their present size essentially through this Huefner and Largay (2004). Several reasons account for this, ranging from the traditional reasons to company specific reasons. We have decided to briefly discuss some of these reasons even though our emphasis is on goodwill. Grinblatt and Titman (1998) identified some of the general potential sources of gains from M&A.

*Operating Synergies:* This center around cost reduction or economic synergies related to economies of scale or scope and lower distribution or marketing costs.

*Tax Motivation:* This includes changes that occur in M&A that reduce tax liabilities, it also include effects from stepping up the basis of the acquired firm’s assets, amortization of goodwill, tax gains from leverage and acquiring tax losses.

*Mispricing motivation:* This occurs if the bidding firms have information about target firms that permit them to identify undervalued firms.

*Market – power motivations:* This is based on the idea that the acquiring firms can gain monopoly in a merger perhaps by buying competitors or foreclosing suppliers.

*Disciplinary takeovers:* This can create value if the acquiring firms recognize managerial shortcomings in target firms and introduce more efficient managers.

*Earnings diversification motivation:* This suggest that acquiring firms focus on diversifying earnings in an attempt to generate higher levels of cash flow for the same level of total risk. This approach substitutes reductions in business risks (earnings fluctuations) for greater financial risk (leverage).

Besides the traditional reasons for M&A, we cannot say with certainty what effect the new rule on goodwill accounting will have on M&A. However, one thing we know for sure is that goodwill account for about 75% of the price paid in an acquisition which is very significant. This means it has to be incorporated in M&A decisions. Our challenge thus lie in investigating how the financial statements of the selected companies will be affected by this new rule .The rationale being that it will enable us understand if these will have any impact in their future M&A decisions.

## **3.2 Goodwill and Accounting Regulations**

### **3.2.1 Accounting for Goodwill according to FASB**

Discussions about the existence of purchased goodwill and how it should be treated are far from new. After several years of discussion and considerations, the FASB issued two standards SFAS

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141‘Accounting for Business Combinations’ and SFAS 142‘Accounting for Goodwill and other Intangible Assets’ that are having a dramatic impact on financial statement information pertaining to M&A and their related goodwill (Massoud & Raiborn, 2003; Huefner & Largay, 2004; Christian et al., 2002; Epstein & Mirza, 2005).

### **SFAS 141: Accounting for Business Combinations**

This statement addresses financial accounting and reporting for business combinations. It superseded APB opinion No. 16, Business Combinations and FASB statement No. 38, Accounting for Pre-acquisition Contingencies of Purchased Enterprises.

SFAS 141 “Accounting for Business Combinations” eliminated the pooling of interest method for a purchase method. Thus all acquisitions initiated after July 2001 were to be accounted for using the purchase method. Due to this, large goodwill balances surfaced in M&A contrary to the now abandoned pooling of interest method putting into evidence some of the overpriced acquisitions of 1990 (Massoud and Raiborn, 2003).

Prior to the issuance of this statement, business combinations were accounted for using the pooling of interest method or the purchase method. 12 criteria were to be made before using the pooling method otherwise the purchase method was to be used. Because those 12 criteria failed to distinguish economically dissimilar transactions, similar business combination were accounted for using different methods that resulted in dramatically different financial statement results (FASB, Homepage).

As a result, analysts and other financial statement users stated that, it was difficult to compare the financial results of entities as different methods of accounting were used. Furthermore, financial statement users also expressed the desire for better information about intangible assets as those assets are an increasing proportion of the assets acquired in many business combinations. While the purchase method recognizes all intangible assets acquired in a business combination, only those intangible assets previously recorded by the acquired entity are recognized in the pooling method.

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SFAS 141 further requires disclosure of the primary reasons for a business combination. It also requires disclosures of the purchase price paid to assets acquired and liabilities assumed by major balance sheet caption.

According to FASB, SFAS 141 will significantly improve financial reporting because the financial statements of entities engaged in business combinations will better reflect the underlying economics of those transactions. Specifically, application of this statement will result in financial statements that; better reflect the investment made in an acquired entity, improve the comparability of reported financial information and provide more complete financial information.

Finally, the FASB concluded that requiring one method of accounting for business combinations is consistent with the concept of representational faithfulness and comparability (FASB, Homepage).

#### **SFAS 142: Accounting for Goodwill and other Intangible Assets**

SFAS 142 deals with financial accounting and reporting for acquired goodwill and other intangible assets. It superseded APB Opinion No.17, Intangible Assets. It addresses how intangible assets that are acquired individually or with a group of other assets should be accounted for in financial statements upon their acquisitions. The statement also addresses how goodwill and other intangible assets should be accounted for after their initial recognition.

The major premise underlying SFAS 142 was that goodwill does not necessarily decrease on a regular and systematic basis. Thus, acquired goodwill may have an indefinite useful life therefore should not be amortized over an arbitrary maximum of 40 years (Massoud and Raiborn, 2003). According to Henning et al., (2004) SFAS 142 eliminates the amortization of goodwill acquired in business combination while providing a two step test that requires the impairment of goodwill when the carrying amount of a reporting unit exceeds its fair value. These changes were intended to address two criticisms of the pre-SFAS No 142 “Accounting rules-the measurement and timing of goodwill write offs.

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The first criticism of pre-SFAS 142 is that the rules provided too much flexibility in measurement of an impairment of goodwill giving firms too much discretion as to the amount of the write-off.

The second criticism of pre-SFAS 142 impairment testing rules is that an absence of a specific impairment “trigger” gave firms too much discretion in timing the write off.

Under SFAS 142, it is difficult to defer an impairment charge. This is because the rule requires goodwill to be tested for impairment at least annually and the impairment test must be applied at the reporting unit level. This rule eliminates enterprise level goodwill and requires firms to allocate goodwill to one or more reporting units as of the impairment testing date. In addition, the new rule obliges firms to measure the impairment by using either a fair value or discounted cash flow.

Analysts, financial statement users, management, noted that intangibles assets are an important economic resource for many entities and an increasing proportion of assets acquired in many transactions (FASB, Homepage). As such better information about intangible assets was needed. Moreover, users of financial statements also stated, they did not regard goodwill amortization expense as being useful information in analyzing investments.

SFAS 142 further requires disclosure of information about goodwill and other intangible assets in the years subsequent to their acquisition. Required disclosures include information such as changes in the carrying amount of goodwill from period to period.

According to FASB, SFAS 142 will permit financial statement users better understand the investment made in a company’s assets and subsequent performance of those investments. Better disclosures about goodwill and intangible assets subsequent to their acquisitions will provide financial statement users with a perfect understanding of changes in those assets over time, thereby improving their ability to assess future profitability and cash flows.



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Finally, the FASB concluded that amortization of goodwill was not consistent with the concept of representational faithfulness. Non amortization of goodwill, coupled with impairment testing is consistent with that concept (FASB, Homepage).

### **3.2.2 Accounting for Goodwill according to IASB**

In March 2004, the IASB also released new standards on Business Combinations (IFRS 3) and Impairment of Assets (IAS 36) (Epstein and Mirza, 2005).

#### **IFRS 3: Business Combinations**

IFRS 3 replaced IAS 22 with the following changes; the preferred method of accounting being the purchase method as against both the uniting and purchase method. All identifiable assets, liabilities and contingent liabilities acquired are measured at 100% of fair values. Good will is not amortized but tested for impairment and negative goodwill is recognize in the profit and loss account immediately. Concerning restructuring cost, it is recognized only to the extent that a liability exists at acquisition date.

Thus, IFRS 3 is applicable for business combinations for which the agreement date is on or after March 31, 2004.

#### **IAS 36: Impairment of Assets**

This standard applies to goodwill and intangible assets acquired in business combinations after March 31, 2004 and to all other assets for annual periods beginning on or after March 31, 2004. IAS 36 had the same resolutions as SFAS 142. It eliminated the amortization of goodwill and stipulates Goodwill should be tested for impairment annually. The passage of this standard saw a lot of opposition from some of IASB constituents and respondent to ED3 who did not want the elimination of goodwill amortization (Shoaf and Zaldivar, 2005). IAS 36 stipulates impairment

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testing should be done whenever there is an indication that an asset may be impaired. At each reporting date, an entity assesses whether there is any indication that an asset may be impaired.

### **3.2.3 Goodwill impairment-FASB**

Following the initial recording of the goodwill, it must be tested annually. The annual test can be undertaken at anytime during the year on a consistent basis from year to year. To test goodwill for impairment, companies must first assign the recorded goodwill to “reporting units”. These could be the companies operating segments or a “components” of a reportable operating segment (Huefner and Largay III, 2004).

In step one, the company estimates the fair value of the reporting units (UFV) and compare it with the unit’s book value (UBV). When the UFV is greater than the UBV, there is no impairment and the test is complete. Warlick (2002) say this is so if; there have been no significant changes in the assets and liabilities. There was a substantial enough margin of fair value in the previous computation. Lastly, there was no adverse event that has occurred since the last test that would indicate a likelihood of loss in fair value substantial enough to fall below the current carrying amount.

On the other hand, if the UFV is less than the UBV, goodwill may be impaired and the company goes to step two. In step two, the company estimates the implied fair value (GFV) of the reporting unit’s goodwill by repeating the process performed at acquisition. This requires subtracting estimated current fair values of the unit’s identifiable net assets (INA) from the units’ estimated fair value (UFA) and comparing the difference with the carrying amount of the goodwill (GBV). When the GFV is less than GBV, the company must record an impairment write off equal to the difference (Huefner and Largay III, 2004).

It should be pointed out that, step one of the impairment testing process is similar with that of IASB. The major difference surfaces with the second step, which is not applicable per IASB rule.

### **3.2.4 Differences between FASB and IASB**

There exist significant differences between the FASB and the IASB standards in accounting for impairment of goodwill and other intangible assets. The differences stem from the impairment testing process. The impairment testing models of the IASB and the FASB have difference bases, in that the FASB compares the carrying value of an asset to its fair value and the IASB compares it carrying value to its recoverable amount, which include value in use. Shoaf and Zaldivar (2005) identified other differences as presented in the table below.

*Goodwill Accounting: An Examination of its impact on mergers and acquisitions decisions*

	<b>IASB(International)</b>	<b>FASB(U.S)</b>
Measurement of impairment	Compare carrying value recoverable amount(the higher of to fair value in use and fair value less costs to sell)	Compare carrying value to fair value
Level of testing for goodwill.	CGU, the lowest level to which goodwill can be allocated and for which management monitors goodwill.	Reporting unit, either a business segment or one organizational level below.
Calculating impairment Of goodwill.	One step: compare recoverable amount of a CGU to its carrying amount	Two step: 1, compare fair value of the reporting unit with its carrying amount including goodwill. If FV is greater than carrying amount, no impairment (skip step 2); 2, compare implied FV of goodwill with carrying amount.
Calculating impairment of Intangible assets	Goodwill and intangible assets with indefinitely live are not tested directly; the CGU to which those assets have been allocated is tested for impairment as a whole.	Goodwill and intangible Assets are tested directly.
Reversal of impairment losses	Applicable to all intangible assets other than goodwill.	Always prohibited

*Table 1 Differences between the FASB and the IASB standards in accounting for impairment of goodwill and other intangible assets.*

### **3.2.5 Effects of the New Goodwill Accounting Rules**

The promulgation of the new rules on Accounting for Business Combinations and Accounting for Goodwill had a dramatic impact on financial statement information relating to M&A and their related goodwill (Massoud and Raiborn, 2003). The impacts of the rules are not very evident in Europe as at now, because these new rules became applicable in 2005. In the US where earlier application was witnessed, a tremendous impact was felt.

Non amortization of goodwill resulted in huge financial loses for some US companies. Reductions in corporations' assets were estimated collectively at \$ 500 billion (Massoud and Raiborn, 2003). Specifically, one third of some 100 US companies with the highest goodwill balances wrote off 30% of their goodwill when they began implementation of SFAS 142 (Huefner and Largay, 2004). The case of AOL Time Warner was particularly significant. A goodwill write off of \$ 54.2 billion was registered. Huge write off were also recorded in other companies for example, the High – Tech Fiber Optic Giant JDS Uniphase (High Tech Fiber, Homepage) announced in April 2001 that is would recognized a \$40 billion write-down of goodwill out of a total of \$56.2 billion on its balance sheet. The amount of the write-down was equal to the extent that the market capitalization of the entire company was less than the carrying value of its net assets (Hoyle et al., 2001).

However, about 100 US companies with the highest goodwill balances witnessed annual profit increases of approximately \$ 20 billion to \$ 25 billion. The elimination of goodwill partially offsets the income reducing effect of impairment write offs. This explains why some of these companies could still have registered profits increases. Nonetheless, net income increases is not accompanied by a corresponding increase in cash flow. Further effects of these new goodwill rules include the following.

Impairment write offs create earnings volatility with no cash flow effects as the write offs indicates a loss in economic value. Increase in return on assets and return on equity measures. These are as a result of higher net income and write off that lower asset.

Lastly, the low equity and assets balances resulting from write offs will lead to increases in debt ratios (Debt/Equity, Total liabilities/Total Assets) creating unfavorable signals.

### **3.3 Sweden**

#### **3.3.1 A Retrospect of Swedish Regulation.**

The first explicit regulation on how to account for goodwill was presented in the Companies Act of 1944 (1944 års Aktiebolagslag). The legislation was changed to the Accounting Act (Bokföringslag 1976) in the mid 1970's. The legislation thus, became applicable not only to limited companies. The likelihood to amortise goodwill over a time period exceeding ten years was annulled.

Purchased goodwill is accounted for as an intangible asset in compliance with chapter 4, section 2 of Årsredovisningslagen (The Accounting Act). Section 5, chapter 4 in ÅRL dealt with rules concerning write-down of fixed assets including goodwill. Write down of goodwill is allowed when the reduction of its value is perceived to be permanent (Maria & Leimalm 2001).

However, these rules are no longer applicable to listed companies. Following the harmonisation of accounting rules in Europe, all Swedish listed companies have to comply with IFRS.

#### **3.3.1 Company Overview**

##### **Volvo Group**

Founded in 1927 with headquarters in Gothenburg Sweden, Volvo group has developed from a small local industry to one of the world's largest manufacturer of heavy trucks, buses, and construction equipments, drive systems for marine and industrial application, aerospace components and services. The group also provides complete solutions for financing and services.

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Several business units provide additional manufacturing development or logistical support. The largest business units are Volvo Power train, Volvo 3p, Volvo IT, Volvo Logistics, Volvo parts and Volvo Technology. Today Volvo has approximately 81.000 employees, production in 25 countries and operates on more than 185 markets.

With a strong presence worldwide and growth, the Volvo group's net sale for 2004 amounted to SEK 201 billion, an increase of 15% compared to last year. Operating income increased to SEK 14.2 billion. Renault being the largest shareholder of Volvo group owns 20, 7% of capital and 20, 5% voting rights.

The mandatory reporting according to IFRS from 2005 in Volvo group like many other companies was not welcomed without consequences. Knowing that Volvo is registered on the New Stock Exchange and complies with FASB, we think the application of the new rule IFRS 3 was without difficulties. However, we tried to understand the ease with which they did their reporting per this new rule and more importantly finding out if and how this new rule would affect their M&A decision.

### **Company Y**

One of the companies that we choose for our research is a large and prominent company in the world of bearings. Because the personnel of the company prefer us not to disclose their identity and that of the company, we are going to refer to the company as Y. It was founded in 1907 and it is the leading global supplier of products, customer solutions, and services in the business of rolling bearings and seals. The company's main competencies include technical support, maintenance services, condition monitoring and training. It also holds an increasingly important position in the market for linear motion products, as well as high precision bearings, spindles and spindle services for the machine tool industry, lubrication systems, and is an established producer of bearing.

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Company Y's business is organized into five divisions; Industrial, Automotive, Electrical, Service, and Aero and Steel. Each division serves a global market, focusing on its specific customer segments. It has 100 manufacturing sites distributed all over the world. It has sales companies in 70 countries and is supported by some 15 000 distributors and dealers worldwide. Its operating profit for the year 2004 stood at SEK 4499 million (Company Homepage).

**Atlas Copco.**

Atlas Copco was founded in 1873. It is an industrial group of companies with headquarters in Stockholm, Sweden. The group has a work force of about 25 000 and has branches in 16 countries. It operates through four business areas; compressor technique, construction and mining technique, industrial technique and rental services. Atlas Copco's operating profit for the year 2004 stood at SEK 6392 million.

As of January 1, 2005 Atlas Copco like all registered European companies began complying with International Financial Reporting Standards. Among these standards is the one on goodwill accounting which is the subject of our thesis.



## **Chapter 4**

### **Empirical Research**

*In this chapter, we present the respondents and their opinions in the different areas described in the theoretical framework.*

#### **4.1 Presentation of the Respondents**

Our prime objective of giving the profile of the respondents is to make the readers aware who they are so that they can be able to trust the sources of the information.

##### **Mr. X, Company Y, Göteborgs, September 6<sup>th</sup>, 2005**

(Because of confidentiality reasons, we were asked not to disclose his identity and his company. Thus, we denote him X and his company Y).

Mr. X has been working at the group accounting of company Y for 6 years. Together with about 60-70 other employees, they are responsible for collecting information required for the internal and external follow up. They also provide up to date information on the rules and oversee the proper implementation of IFRS rules in the different units of the company. Before working with company Y, he worked as a finance manager in a small Swedish company.

##### **Annika Gustavsson, Volvo Group, Göteborgs, September 20<sup>th</sup>, 2005**

Annika Gustavsson works with the group accounting at the control department of Volvo Group. She has been working there for quite some time. She is responsible for the preparation of internal and external management reports or external financial information. She oversees the proper

implementation of accounting principles by the different units. She is also responsible for collecting information from the subsidiaries for the preparation of annual reports.

### **Ulf Gillberg, Volvo Group, Göteborgs, October 24<sup>th</sup>, 2005**

Ulf Gilbert is the director of corporate finance. He has been working with M&A for nine years and two and a half years at the M&A department of Volvo group. He also works with issues related Volvo's capital structure.

### **Johanna Tesdorp, Atlas Copco, Stockholm, November 16<sup>th</sup>, 2005**

Johanna Tesdorp has been working with Atlas Copco for five years. She works with the company's M&A department and has been working there for the last four years. Before joining Atlas Copco, Johanna, worked for a management consultancy firm for two years.

Johanna and other staff of the M&A department have as responsibility to develop the acquisition process of the company which involves determining the type of acquisition and how it should be done.

## **4.2 Presentation of Respondent's Opinions**

*Here, we present the opinions of the respondents with regards the following;*

### **4.2.1 Goodwill Accounting and its Application**

We wanted to find out the ease with which these new rules (IFRS 3 and IAS 36) were implemented in the different companies. All respondents had the same opinion regarding their implementation.

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Mr. X says his company had no difficulties with implementing the new goodwill accounting rules. He states that though IAS 36 like all other IASB pronouncements went into effect in 2005, his company began its implementation in 2002 especially intangible assets which was equivalent to IFRS pronouncements. He says

“We had put it into process, so it is not a big issue for us.”

He states that the only difference between impairment of assets according to Swedish GAAP and IASB impairment of assets is that the latter requires companies to test for impairment annually. Per IFRS 3, Mr X points out that

“Changes in IFRS 3 is not a major change from what we doing before. Goodwill amortization was not allowed any more according to Swedish GAAP.”

He further explains that, the non amortization of goodwill has been earlier applied when they were doing the purchase price allocation. So complying with IFRS 3 and IAS 36 was done with relative ease.

Annika confirms that, they had no problems implementing the new rule as impairment testing had been done in Volvo since 2002 with US GAAP. She adds that

“Volvo is registered on the NASDAQ and we have been applying SFAS 142 and SFAS 142 for two years. So this was the earliest part of the IFRS transition.”

Annika further says information on amortization per business areas and quarters had been reported since then. This is because they had anticipated these changes and possible effects on the whole group. Thus the transition was quite easy for Volvo as they already had the information required and only needed to reverse the goodwill balances recorded in previous years.

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According to Johanna, implementation of IAS 36 was quite easy in her company. As required by IAS 36, her company did impairment testing at year end 2004 and has already done so this year in the hard close statements. She says

“We have developed the discount cash flow model which we use for the impairment testing process.”

She also states the process of application was sufficiently discussed with their auditors. Because IAS 36 stipulates impairment testing of goodwill be carried out at the cash generating units, Johanna says Atlas Copco and its auditors had to decide what should constitute the cash generating unit. They finally decided the business divisions should be considered the cash generating units.

#### **4.2.2 Measures to avoid errors of impairment testing**

The first step of the impairment testing process entails allocating fair value to reporting units. Knowing that this may be judgmental and induce errors which can make the whole testing process bias, we wanted to find out if and how these companies minimize these errors. All respondents are of the opinion that models have been put in place to minimize errors.

Mr. X says stringent measures are use to avoid errors as they apply the two steps of impairment testing. He says

“First we identify the cash generating units and allocate goodwill values to them. We then test for impairment. We use a discount price forecast, we estimate the cash flows, the sales margins, investments, etc. Everything is judgmental but it is base on estimates made by our business divisions base on their business approach.”

Mr X further says, the test is repeated year after year to see if estimates have changed. If it does, concrete reasons have to be advanced for that. He however admits that lots of judgment involved in the process especially when doing estimates can truncate the results. To curb this, he states that

“We have a process that is reviewed by us internally, by our business division and by our auditors.”

Annika reiterates that they were prepared for the changes hence their error margin is minimal. For an efficient impairment testing process, she says

“We have an excel model in which assumptions and instructions are made. We distribute it with any one concern with the implementation of the process. The information are collected and cross checked to see if there are errors.”

She further states as the basis of the impairment testing, they do a four year forecast of cash flow. She however admits this is a major critic to include in accounting but says it can be justified.

Johanna acknowledges the fact that the impairment testing process involves lots of judgments and it is often very difficult making assumptions about the future.

“Atlas Copco has a model which we use for the process, the discount cash flow model.”

She says the numbers they use for the process is based on their internal planning process where the different divisions decide what targets they have and where they intend to be in three years. These numbers are used together with analysts’ presumptions regarding the market around them. In a not shell, they make sure their internal assumptions tie with market specialists forecasts.

### **4.2.3 Reliability of the Goodwill Value**

We were interested in knowing how reliable were the goodwill value of recent acquisitions. That is, on what grounds did specialists arrived at the goodwill value. Some of the respondents acknowledge the fact that this was tricky as they were not directly involved in the acquisition process and were tactful in their responses.

Mr X says they have not done any major acquisition of recent. He points that, it is difficult to determine the goodwill value with reliability as the different components of intangible assets need to be identified and value allocated to them. Hence the process demands a lot of disclosure. He says

“When we takeover a company, we have as major task to convert the book value or equity of the acquired company from the local GAAP to IFRS. We then review all the items on the company’s balance sheet to estimate its worth.”

Mr X also points to the fact that they usually hire the services of external valuers to help them in the process. He says the estimated value is deducted from the amount paid to arrive at the goodwill value.

Annika says the acquisition of Renault trucks was the most recent acquisition of Volvo group with lots of specialist involved. This acquisition produced high goodwill balance and the price was equally very high. She adds at the rationale for paying that much was because the specialists knew it was a good deal as it was finance through the exchange of shares.

Gillberg added that the goodwill value can be reliable. He states that before they arrive at an acquisition price, the assets and liabilities of the acquired company is compared with those of similar companies. This is to make sure they do not pay a price that will be questioned by shareholders. He further says specialists allocate values to assets using valuation models that have been tested. He adds that

“The biggest issue is to allocate value to goodwill and other assets. As a rule of thumb, we use the 50/50 model in which 50% is goodwill and the remaining 50% is allocated to other intangible assets.”

He goes further to explain that these specialists reduce the goodwill value recorded on the balance sheet during the valuation, because of the uncertainty effect.

For Atlas Copco to be certain that the value attributed to goodwill in an acquisition is reliable, Johanna says they evaluate the assets and liabilities on the acquired company’s balance sheet.

“We try to identify all intangible assets we buy like customer lists, patents and trade marks and allocate value to them.”

She also points to the fact that sometimes, they seek the services of appraisal companies to help them in the process.

#### **4.2.4 Effects of the rule on financial statements**

We were very much interested in knowing the effects of the new rules on the financial statement of the different companies. The respondents presented opposite views.

Mr. X says the goodwill amount on the balance sheet is very small, this is due to the fact the company has not been involved in any major acquisition recently. He says

“Even if we make write-offs goodwill due to impairment losses, it will not have an impact on our company’s total business as the goodwill amount is insignificant. Goodwill has not been a major accounting issue in our company.”

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According to Annika, changes in goodwill accounting rules had a positive effect on the company's financial statements. She says

“We had an MSEK 684 improvement of the operating income due to the reversal of the goodwill amortization.”

She further says for Volvo to write down assets due to impairment losses is very unlikely as all their business areas are very profitable. Gillberg was of the opinion that due to the nature of Volvo business (truck business) the goodwill effect on the financial statement will be insignificant due to its small amount.

Johanna says changes in accounting treatment for goodwill had a positive effect on Atlas Copco's financial statements. She says the company's operating profits increased by MSEK 454 due to elimination of goodwill amortization.

#### **4.2.5 Reaction from creditors**

Here we wanted to find out how creditors and other stakeholders reacted to the companies shares after the implementation of the new accounting rule on goodwill.

Mr. X says no effects were felt by the company, as such no reaction from creditors. To justify this, he adds that his company has a good equity rate thus, high credit rating.

Annika believes there are no questions from creditors on this new rule as all calculations and discussion are readily accessible (either from the annual report or the company's website) hence, questions related to this have been fully addressed.



#### **4.2.6 Effects of the new rule on M&A decisions**

Mr. X has very strong views that the new goodwill accounting rules will not affect his company's M&A decisions. He adds that

“Top management is not very interested in accounting issues like amortization, impairment testing and this will not affect our future acquisitions. Rather we will focus on business areas.”

However, he explains that accounting issues have a great impact, even though management is not very interested in these issues when going into an acquisition.

Annika also thinks that goodwill will not affect any future acquisition of Volvo. For Volvo to go into an acquisition, management identifies synergies so that the risk of impairment is minimized. She explains that Volvo has so much cash at the moment and there is an enormous pressure for them to do an acquisition provided the price is good. The emphasis is on the price and the synergy effects.

Gillberg too was more concerned with the synergies to be gained. Nevertheless, he makes it clear that some consideration can be made depending on how EPS may be affected.

“If the goodwill accounting rule will have a dilutive effect on EPS, then a second thought have to be given, otherwise no other reasons can hinder us from going into a profitable a strategic acquisition.”

Johanna says management considers goodwill before going into an acquisition, though it is not a driving force. This is because it is impossible to acquire a company without buying goodwill. She points that

“Goodwill is one parameter that we think of in an acquisition decision but it is not making or breaking the deal. It is certainly a parameter you think of.”

## **Chapter 5**

### **Analysis**

*In this chapter, we tie together the theory and the empirical research of the study. Some issues that were not mentioned in the theoretical framework but which we found interesting in the course of the empirical research will also be discussed. The objective of the analysis is to gain an understanding of if and how the new goodwill accounting rules will affect companies' M&A decisions.*

*Though the effects of the new goodwill accounting rules on M&A decisions is the prime issue of this thesis, other issues we believe are of interest and relevance are also looked into. The analysis will thus be done under the following sub headings.*

#### **5.1 Goodwill Accounting and its application**

This findings of this study revealed that all the companies under investigation implemented the new goodwill accounting rules with relative ease. Two of the three companies we interviewed are registered with the New York Stock Exchange and are required to comply with FASB rules. These companies started implementation of the new goodwill accounting rules in 2002. Moreover, Swedish GAAP endorsed impairment of assets in 2002. The Accounting Act permits write-down of goodwill, when a reduction of its value is perceived to be permanent (Maria & Leimalm 2001). Thus, as of 2002 all registered Swedish companies were required to test their assets for impairment. Compliance to IASB goodwill accounting rules in 2005 was therefore relatively easy for them.

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Some of the reasons the FASB and the IASB advocated for the change in goodwill accounting rules were that, the future effects of business combinations were hard to quantify and to compare between companies. Many financial statement users complained that the details of merger-and-acquisition transactions were difficult to understand. The FASB and IASB state applications of these rules will provide complete financial information. But how close are the FASB and the IASB to achieving this target? The nature of accounting rules especially those made by the IASB, leaves a lot at discretion of companies when applying the rules. Companies could manipulate the implementation of these rules to suit them especially as they are dealing with intangibles. The WorldCom and Enron debacle are still fresh in our minds.

The application of these new goodwill rules has little to do with companies' M&A decisions but the effects these rules will have on companies and their probably M&A decisions will undoubtedly be affected by how companies implement them. As such we found it necessary throwing an eye on the application of these rules in the companies under study. Proper implementation of the new goodwill accounting rules is essential, as this could distort the outcome of the study. Management may be induced into taking a particular decision on issues like M&A due to misappropriateness of accounting rules. As discussed in Chapter four, all the companies we interviewed met no difficulties complying with these new goodwill rules. This is a good indication, as it signifies the companies have an in-depth knowledge per the application of the rules. The likelihood of misinterpretation of the rules is thus minimal. Moreover, the application of the rules is reviewed by auditors. This certainly instills trust in the process.

However, as seen in the introduction of the thesis, our inspiration for carrying out this study stems from the substantial effects these rules had on companies in the US. Still, there exist some differences between FASB and IASB goodwill accounting rules (Shoaf & Zaldivar, 2005). For instance, per IASB rules, in calculating for impairment, goodwill and intangible assets with indefinitely lives are not tested directly; the CGU to which those assets have been allocated is tested for impairment as a whole. Whereas according to FASB rules on impairment of assets,

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goodwill and intangible assets are tested for impairment directly. Will these differences in accounting treatment for goodwill result in European companies having a greater/lesser impact of the rules? We think these differences will certainly affect the impact of these rules on European companies. The magnitude to which these differences will cause on the effects of these new goodwill rules on European companies will be very difficult to determine if not impossible. The results of this thesis are thus valid in only in countries complying with IASB rules.

## 5.2 Measures to avoid errors of impairment testing

Intangible assets among which is goodwill are an important economic resource for entities and an increasing proportion of assets acquired in any transaction (FASB, Homepage). While they play an important role in today's business world, quantifying their value is problematic. The IASB and FASB both stipulate an impairment review for goodwill valuation. As discussed in chapter three, impairment testing should be undertaken at anytime during the year on a consistent basis from year to year. To test goodwill for impairment, companies must first assign the recorded goodwill to "reporting units". The company estimates the fair value of the reporting units and compares it with the unit's book value. If the fair value is greater than the book value, there is no impairment and the test is complete. On the other hand, if the fair value is less than the book value, goodwill may be impaired.

The process is quite complex as it deals with fair value measurement. Moreover lots of debate surrounds the fair value price. Management has often used the idea of fair value to mislead their shareholders. Using fair value requires a lot of judgments, assumptions and forecasts, as the fair market price is never constant. The impairment testing process may eventually result in huge goodwill write-off. This may have severe effects on companies' financial statements and as such management's decisions on M&A.

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However, there is little evidence to support the fact that the impairment process will directly affect companies' M&A decisions. The resultant effect of the process on financial statements will certainly do. We however believe assessing the impairment testing process in our chosen companies was necessary as to give this thesis the needed credibility. We needed to make sure management's M&A decisions is not motivated by underlying effects of error in impairment testing process.

All the companies we interviewed demonstrated an in depth knowledge about impairment testing as they have developed models for implementing the process. The discounted cash flow model is the most commonly used. Becker et al., (2002) also supports this fact. The cash generating units are identified and tests carried out on these units at least annually. In so doing, they perfectly comply with IASB rules on the issue. The companies nonetheless accepted the process involves a lot of judgments and assumptions. To minimize errors, they say the process is reviewed by themselves and their auditors. The companies also made mention of the fact that, they were doing impairment testing (under Swedish GAAP) prior to adoption of IASB rules. This indicates the IAS 36 is not new to them as such we they can possibly implement it will little risk of errors.

### 5.3 Reliability of the Goodwill Value

The big question has always been how reliable is the value attributed to goodwill in an acquisition? The task of determining the goodwill value in an acquisition is quite complex. As discussed in the chapter four, all our respondents acknowledge this fact. Kieso et al (2001) state goodwill is the residual, the excess of the cost over the fair value of the net identifiable assets. Determining the fair value of the net identifiable assets will definitely involve a number of assumptions and minor changes can substantially affect the results. Every judgment and assumption a company makes is thus subject to second guessing by auditors, regulators and the press (Sayther, 2004). Controversy can thus surround the reliability of the goodwill value. Determining the fair value of the net identifiable assets clearly creates the potential for unintentional or intentional bias. Management may easily manipulate such values to its advantage.

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As this study deals with the effects of the new goodwill accounting rules on M&A decisions, we found it important reviewing the goodwill amount in the chosen companies' balance sheet. There is no direct relationship between the goodwill amount on the balance and a company's M&A decisions. But the effects, possible write-offs of goodwill could have on a company's financial statements may affect its M&A decisions. Without the correct goodwill amount on the balance sheet, the identified effects of the new rules would certainly be a wrong signal.

As discussed, in chapter four, all the companies solicited the services of external valuers in the process. Could this be due to lack of technical know how on their part, or was it due to the intricacy of the process. The fact that all the companies used the services of appraisal companies implies this is a common practice of companies. In the aftermath of the Enron debacle, users of financial statements became skeptical of homemade valuations. As a result, companies need to call on experienced outsiders for valuation services. Appraisal companies are specialists in this domain can possibly determine the goodwill value with little risk of errors.

## 5.4 Effects of the new rules on financial statements

Financial statement results could be considered as basis for management's decision making. These statements reflect the underlying decisions management has taken through out the year. In a nutshell, they serve as a yard stick for judging management's performance. We believe looking at the effects of these new rules on financial statements is imperative as base on these effects management's M&A decisions may rely.

As discussed in chapter four, our respondents witnessed slight divergent on this is issue. Two of them witnessed increases in operating income following implementation of the new rule while one witnessed no effect. The underlying effect to be borne by the company is heavily dependent on the company's goodwill amount. In the event of a company with low goodwill balances writing off goodwill due to impairment losses, the company's total business will not be affected. This is because the goodwill amount is insignificant. On the contrary, the effects of these new rules are more perceived in companies with high goodwill balances. As seen in chapter three, non

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amortization of goodwill resulted in huge financial losses for some US companies. Reductions in corporations' assets were estimated collectively at \$ 500 billion (Massoud and Raiborn, 2003).

The case of AOL Time Warner was particularly significant. A goodwill write off of \$ 54.2 billion was registered. However, increases in operating income could also be noticed. This was the case with two of the companies studied. This is due to the fact that, the elimination of goodwill amortization partially offsets the income reducing effect of impairment write offs. These new rules will certainly have a positive effect in companies having profitable business units with little risks of impairment write-offs. This holds true where the business units are considered to be cash generating units. For example Volvo, Volvo has very profitable business units; the possibility of impairment write-offs is thus very slim.

In a nutshell, the effects of these new rules on financial statements will depend on the goodwill amount on the company's balance sheet. Depending on the magnitude of the effects on the financial statements, companies M&A decisions will either be affected or not.

## 5.5 Effects of the new Rules on M&A decisions

The effect of the new rules on M&A decisions is the prime issue of this thesis as seen in the introductory chapter. As discussed in chapter four, our respondents had divergent opinions on this issue. Some of them affirm these new rules will not affect their M&A decisions while others were of a contrary view. It could be observed that the companies who affirmed that these rules will not affect their M&A decisions had very small amounts of goodwill in their books. Possible write-offs due to impairment losses will have little or no effects on the financial statements of such companies. On the contrary, companies with considerable goodwill amount on their balance sheet affirm these new rules will affect their M&A decisions. This implies possible write-offs will have consequential effects on such companies' financial statements. This was the case with several US companies following the promulgation of SFAS 142 (Huefner and Largay, 2004).

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The effect of these new rules on M&A decisions depends on the structure of the company in question. That is, the proportion of the companies intangible assets to other assets. The kind of business activity a company is into plays a significant role in determining its proportion of intangible assets to tangible assets. For instance, companies in the telecom industry are well known to have high goodwill balances. This industry is also known for its high prevalence of M&As. In such an industry, these new rules will surely affect M&A decisions. Moreover, this industry witnessed heavy write-offs following the passage of SFAS 142 in the US. For example JDS Uniphase, a High Tech Fiber Optic Giant recognized a \$40 billion write-down of goodwill out of a total of \$56.2 billion on its balance sheet (High Tech Fiber, Homepage). Some companies in Sweden also registered impairment write-offs following passage of the rule on impairment of assets by the Swedish accounting standards board. Atlas Copco, a Stockholm based company recorded an impairment write down of SEK 7bn. Most often, companies look at the effects these new goodwill accounting rules will have on their EPS. For instance, as we discussed in the previous chapter, Volvo says if these new rules will have a dilutive effect on EPS, then it could affect their M&A decision. Otherwise, no other reasons can hinder them from going into a profitable and strategic acquisition.

Companies with high goodwill balances will definitely consider goodwill before going into an acquisition whereas those with low goodwill balances will not. Rather the latter will focus on other strategy reasons.



## **Chapter 6**

### **Conclusion**

*In this chapter, we draw our conclusions based upon the discussion in the analysis. The conclusion will provide an answer to the research problem. Suggestions for further research are also provided in areas related to the thesis subject.*

This thesis has attempted to find out if the new goodwill accounting rules will affect companies M&A decisions. An in-depth study was carried out in some Swedish companies. The main research question is:

Will the new accounting treatment of goodwill affect M&A decisions?

Other issues we believed are of interest and relevance was looked into as this will permit us provide answers to our other research questions.

These rules will affect M&A decisions in companies with high goodwill balances whereas we do not think it will affect M&A decisions in companies with low goodwill amounts on the balance sheet. We believe depending on the magnitude of the impact of the rules on the financial statements, companies M&A decisions will rely. From our interviews, the companies with low goodwill amounts on their balance sheet revealed that, these new rules will not affect their M&A decisions whereas, the company with high goodwill amount on its balance sheet affirm these new rules will affect its M&A decisions. A high goodwill amount on a company's balance sheet implies greater effects will be felt by the company as a result of the new goodwill accounting rules. The kind of business activity and industry a company belongs to is very important in determining the size of intangible assets. Companies in the telecom industry generally have high goodwill amounts on their balance sheet. We think, these companies will witness a greater effect

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of the new rules. This was the case of JDS Uniphase, which recognized a \$40 billion write-down of goodwill out of a total of \$56.2 billion on its balance sheet. We thus are of the opinion that the new accounting treatment of goodwill will affect M&A decisions in companies with high goodwill balances. We do not think it will affect M&A decisions in companies with low goodwill amounts on the balance sheet.

In deciding whether to consider the new goodwill rules in their acquisition policies, companies study the effects these rules have on their financial statements. Companies will definitely look at the implications of the financial statements following write-offs of goodwill. We believe companies M&A decisions will depend on the magnitude of these effects. The implications of the financial statements following write-offs of goodwill will depend on a company's goodwill carrying amount. In the event of a company with low goodwill balances writing off goodwill due to impairment losses, the company's total business will not be affected. This is because the goodwill amount is insignificant. On the contrary as discussed earlier, the effects of these new rules are more perceived in companies with high goodwill balances.

Since this study deals with goodwill, we found it imperative reviewing the goodwill amounts on our chosen companies' balance sheet. We do not find any direct relationship between the goodwill amount on the balance and a company's M&A decisions. But we think the effects, possible write-offs of goodwill could have on a company's financial statements may affect its M&A decisions. Without the true goodwill amount on the balance sheet, the identified effects of the new rules would certainly be a wrong signal. To the best of our knowledge, we strongly believe the goodwill values of the companies we interviewed are reliable. Appraisal companies were used in the process of initiation recognition of goodwill. These are specialists and are independent of companies' management. They will without doubt produce statements that reflect the true picture of companies. Furthermore, the interviewed companies demonstrated an in depth knowledge about impairment testing process. They have developed models for implementing the process. The risk of error in the process is thus very unlikely. Moreover, the impairment testing process is reviewed by auditors.

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To sum up, we are of the opinion that the new goodwill accounting rules will affect some companies M&A decision.. The argument here depends on the goodwill amount on the statement of financial position and its effects on earnings per share (EPS).

## **Suggestions for further research**

We have suggested the following for further research:

- We also believe it would be fascinating to conduct a similar study in a few years to come when all listed companies must have fully complied with the rule. A larger sample size could be used.
- A similar study could be carried out with focus on service industries with high Goodwill balances.
- It would be interesting to carry out a study on the effects of IFRS 3 and IAS 36 on financial statements; a case study of European companies.
- Another interesting topic would be to look at the differences between FASB and IASB rules on goodwill.
- A study on the different valuation methods used by Swedish Companies could be looked at.

## **Chapter 7**

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## **Appendix**

*In this section, we will present the questions asked the interviewees.*

### **Questions for Mr X of Company Y**

Cognizance of the fact that most large companies have attained their present size mainly through mergers and acquisitions and knowing fully well that in most of these acquisitions, goodwill amounted to 75% or more of the total price paid, our challenge is to investigate the impact of the new accounting of goodwill on M & A decisions. This gap is what we aim to fill with the present thesis by carrying out a study on some Swedish companies.

- 1      Following the adoption of the new rules; IFRS 3, “Business Combinations” together with IAS 36, “Impairment of Assets”, companies are expected to perform the transition review for impairment of goodwill. How easy were you to complete both steps before the issuance of your first two quarters results?
- 2      What measures were carried to avoid errors or perfect impairment testing approach?  
(To look for some errors, example judgmental)
- 3      How reliable was the goodwill value of your most recent acquisitions, i.e. on what grounds did the specialists based their arguments before arriving at the goodwill amount?

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- 4 In the USA, the new accounting rule for goodwill was experienced with a lot of losses in companies, for example, On January 7, 2002, AOL Time Warner announced it expected to take a goodwill write-off of up to \$60 billion (almost half the amount recorded pursuant to the merger), what are your views on this as regards European companies, particularly Company Y?.
  - 5 Doing a retrospective adjustment of the statements, did you record higher/lower earnings? Could this in any way be related to the new accounting rule for goodwill?
  - 6 According to this rule what was the situations on liabilities/total assets, equity / total assets, and any possible reactions from creditors?
  - 7 What is your opinion on how the above could affects future acquisitions?
  - 8 Apart from other reasons for mergers and acquisitions, can you tell us to what extent goodwill played in your company's M & A decisions?

Question for Annica Gustavsson, Volvo.

Considering the fact that, companies' M&A decisions might be significantly influenced by the effects the new goodwill accounting rules may have on the financial statements, we intend to look at the implications on the financial statements following the write-off of goodwill. Prior to meeting this objective, we find it necessary to look into the reliability of the value attributed to goodwill in your company. To ensure credibility, the impairment testing approach for goodwill revaluation is also examined.

- 1 Following the adoption of the new rules; IFRS 3, "Business Combinations" together with IAS 36, "Impairment of Assets", companies are expected to perform the transition review for impairment of goodwill. How easy were you to complete both steps before the issuance of your first two quarter results?



- 2 What measures were carried to avoid errors or perfect impairment testing approach? (To look for some errors, example judgmental)
- 3 How reliable was the goodwill value of your most recent acquisitions, i.e. on what grounds did the specialists based their arguments before arriving at the goodwill amount?
- 4 In the USA, the new accounting rule for goodwill was experienced with a lot of losses in companies, for example, On January 7, 2002, AOL Time Warner announced it expected to take a goodwill write-off of up to \$60 billion (almost half the amount recorded pursuant to the merger), what are your views on this as regards European companies, particularly VOLVO?.
- 5 Doing a retrospective adjustment of the statements, did you record higher/lower earnings? Could this in any way be related to the new accounting rule for goodwill?
- 6 According to this rule what was the situations on liabilities/total assets, equity / total assets, and any possible reactions from creditors?

### Question for Johanna, AtlasCopco

Considering the fact that, companies' M&A decisions might be significantly influenced by the effects the new goodwill accounting rules may have on the financial statements, we intend to look at the implications on the financial statements following the write-off of goodwill. Prior to

meeting this objective, we find it necessary to look into the reliability of the value attributed to goodwill in your company. To ensure credibility, the impairment testing approach for goodwill revaluation is also examined.

1. Following the adoption of the new rules; IFRS 3, "Business Combinations" together with IAS 36, "Impairment of Assets", companies are expected to perform the transition review for impairment of goodwill. How easy were you to complete both steps before the issuance of your first two quarter results?
2. What measures were carried to avoid errors or perfect impairment testing approach? (To look for some errors, example judgmental)
3. There was a lot of controversy surrounding your amortization plan. Could you throw more light on this? For example, you allocate different number of years to different acquisitions (Strategic acquisition, other acquisition).
4. Looking at the end of year balance sheet for 2004, Intangible assets were 10,984 millions sek. How much was goodwill?
5. From the first two quarter results, it can be noticed that the value for intangible assets dropped to 10,174. What reasons accounted for this?

6. From January 2005, your company has done quite some numbers of acquisitions. How reliable was the goodwill value of your most recent acquisitions, i.e. on what grounds did the specialists based their arguments before arriving at the goodwill amount?
7. In the USA, the new accounting rule for goodwill was experienced with a lot of losses in companies, for example, On January 7, 2002, AOL Time Warner announced it expected to take a goodwill write-off of up to \$60 billion (almost half the amount recorded pursuant to the merger), what are your views on this as regards European companies, particularly AtlasCopco.
8. Doing a retrospective adjustment of the statements, did you record higher/lower earnings? Could this in any way be related to the new accounting rule for goodwill?
9. According to this rule what was the situations on liabilities/total assets, equity / total assets, and any possible reactions from creditors?

### Question for Gillberg, Volvo

Considering the fact that, companies' M&A decisions might be significantly influenced by the effects the new goodwill accounting rules may have on the financial statements, we intend to look at the implications on the financial statements following the write-off of goodwill. Prior to meeting this objective, we find it necessary to look into the reliability of the value attributed to goodwill in your company. To ensure credibility, the impairment testing approach for goodwill revaluation is also examined.

- 1 How reliable was the goodwill value of your most recent acquisitions, i.e. on what grounds did the specialists based their arguments before arriving at the goodwill amount?
- 2 In the USA, the new accounting rule for goodwill was experienced with a lot of losses in companies, for example, On January 7, 2002, AOL Time Warner announced it expected to take a goodwill write-off of up to \$60 billion (almost half the amount recorded pursuant to the merger), what are your views on this as regards European companies, particularly VOLVO?.
- 3 Doing a retrospective adjustment of the statements, did you record higher/lower earnings? Could this in any way be related to the new accounting rule for goodwill?
- 4 What is your opinion on how the above could affects future acquisitions?
- 5 Apart from other reasons for mergers and acquisitions, can you tell us to what extent goodwill played in your company's M & A decisions?