COMMENT LETTER ON THE EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO

IFRS 3 BUSINESS COMBINATIONS

Submitted by: The European Accounting Association

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Introduction

The European Accounting Association (EAA) organizes approximately 1500 accounting academics at universities in Europe and the rest of the World. The EAA has created a Financial Reporting Standards Committee, which will provide comments on exposure drafts of standards.

The comment letter begins with an overview of literature related to business combinations. This is followed by answers to the specific questions stated in the Invitation to Comment.

The literature review is divided into the following sections:

2. Asset valuation
3. Intangible assets
4. Goodwill valuation
5. Usefulness of fair value
6. Minority interest
7. Accounting treatment – effects on users
8. Accounting treatment – company incentives
9. Accounting treatment – other effects
10. International accounting diversity

1. History/Nature of Goodwill

Goodwill, both in business combinations and in other settings, has been an issue in accounting for more than a century (Hughes, 1982; Falk and Gordon, 1977). Some argue that the lengthy debate is caused by an inability to agree on the nature of goodwill.

Miller (1973) claims that the problem of goodwill in accounting stems from a mismatch between accounting based on aggregation and a focus on value in accounting. Falk and Gordon (1977) conclude that goodwill is a result of imperfect competition. Ma and Hopkins (1988) argue that purchased goodwill does not meet the definition of an asset, since it cannot be linked to any future stream of benefits. This claim was debated a few years later (Grinyer and Russel, 1992; Ma and Hopkins,
More recently, Power (2001) contends that in order to understand goodwill, accountants must determine the constituent parts of goodwill.

These studies appear to support the general approach to goodwill in IFRS 3, i.e. that purchased goodwill should be minimized through allocation to identifiable intangible (and tangible) assets. Further, goodwill should not be amortized, as it cannot easily be linked to economic benefits in specified accounting periods. The shift from aggregation to fair values in step acquisitions is supported by Miller.

2. Asset Valuation

Goodwill is one asset that has been subject to accounting debates. In IFRS 3, more or less the entire balance sheet of the acquired company should be remeasured at fair value at the time of acquisition. This gives rise to a few issues.

First, since values of individual assets and liabilities are related to the acquisition price paid in the business combination, is there support in the literature that there is substance behind prices paid? Several studies indicate a poor performance after acquisitions (Conn et al, 2005; Gregory, 2005; 1997; André et al, 2004). Other studies indicate no abnormal return after acquisition (Gregory and McCorriston, 2005), or claim that the return cannot be reliably measured (Sudarsanam and Mahate, 2003). Further, there are attempts made at explicitly identifying reasons for value gains in acquisitions (Ghosh, 2004; Sudarsanam, 2004; Sudarsanam et al, 2002; 1996). In summary, research to date is inconclusive as to support for asset values in acquisitions.

Second, there is the issue of to what extent it is possible to determine a value of individual assets and liabilities independently of the acquisition price paid in the business combination. Two studies measuring this found some reliability problems, but still an improvement over historic cost measures (Brown et al 1994; Dietrich et al 2001). Thornton found measurement error, but no bias in fair values (1988).

In summary, the existing literature does not preclude the recognition of assets at fair value in business combinations.

3. Intangible assets

The group of assets that pose the greatest challenge in restating at fair value are intangible assets. They are often difficult to value, in part due to their high degree of specificity. Because of their perceived increasing importance (e.g. Günther and Kriegbaum-Kling, 2001; WGARIA, 2005), they have been much studied lately.

The difficulty of valuing intangible assets is reflected in a higher analysts’ following of companies with a high percentage of intangible assets (Barth et al, 2001). It is also reflected by the reporting alternatives available to companies in practice, which has given rise to the concept of “fudged accounting theory” (Ong, 2003; Ong and Hussey, 2004).

Several studies have linked the reporting of intangible assets with users. Choi et al (2000) show that stock markets puts a value on reported intangible assets, but this
value is lower than for other reported assets. Further, the market does not value amortization of intangible assets. Amir and Livne (2005) have similar findings, indicating that accounting users see intangibles as economic assets (at least for a limited period), but the users do not see the amortization as an economic expense. The lower usefulness of reported intangible assets compared to other assets is also reflected in the internal use of such accounting numbers ( Günther and Kriegbaum-Kling, 2001; Krolick, 2005).

Thus, research suggests that it is useful to include intangible assets at fair value in business combinations. Amortization of such assets may not provide information to accounting users. Also, the relevance of intangible assets is lower than that of other assets. Gröjer (2001) suggests that the lower relevance might be mitigated by a different classification of intangible assets.

4. Goodwill valuation

As indicated earlier, goodwill is the intangible asset that probably creates the greatest valuation challenges in accounting.

Previously, goodwill was recognized on acquisition, and amortized systematically over a number of years, in most countries. Thus, accountants rarely had to value goodwill separately from a transaction involving an acquisition. Now, with annual impairment testing, accountants must value goodwill at least annually. In this endeavor, accountants tend to perform tasks previously performed by the users of accounting. As pointed out in Vincent et al (2001) and Lander and Reinstein (2003) this involves the use of various equity valuation models.

In practice, Dunse et al (2004) point to the difficulties practitioners have in allocating value to goodwill, especially in deciding what is goodwill and what represents other, identifiable intangible assets. Davis (2005), on the other hand, claims that new rules enable firms to better reflect economic events in their post-acquisition reporting. Further, Wyatt (2005) shows that the abolition of forced amortization, and more judgment in goodwill valuation, is likely beneficial in financial reporting.

The literature appears to suggest that the change in accounting for purchased goodwill have, despite some difficulties for accountants, resulted in higher quality financial reporting. A separate issue is that goodwill as an asset may have a weak conceptual foundation in accounting theory, as pointed out by Hodgson et al (1993).

5. Usefulness of Fair Value

Since IFRS 3 entails an increased usage of fair value reporting in business combinations, it is of interest to summarize what research says about the usefulness of fair value in accounting. A multitude of studies on the topic has been performed in the last decade, especially with a focus on the use of fair value for financial instruments.

Many of the studies have looked at the usefulness of fair value reporting from an investor perspective. Results are mixed. Limited relevance of fair value is found by Mozes (2002), Nelson (1996), Beatty et al (1996), Eccher et al (1996), Millon Cornett et al (1996), Lys (1996), Khurana and Kim (2003), and Simko (1999). Other studies
criticize these results, and find usefulness of fair values, sometimes by adding additional structure in the studies (Park et al, 1999; Beaver and Venkatachalam, 2003; Wahlen, 2003; Carroll et al, 2003; Barth et al, 1995; 1996; Barth, 1994; Venkatachalam, 1996).

As noted, the evidence on the usefulness of fair value reporting is mixed in the literature. Further insight into the issue is gained by focusing on the producer and regulatory aspects. Martens and Berry (2003) show that it is difficult to estimate fair values using the guidance provided in SFAC 7. Barlev and Haddad (2004) claim that the control systems used in accounting must be changed in order to better fit the fair value reporting model. Sloan (1999) indicates a low reliability in the production of fair value accounting numbers. Nissim (2003) shows that the reliability of fair value estimates is decreased by management incentives in the reporting process.

To conclude, it appears that there is mixed evidence on the usefulness of fair value reporting. This is, at least to some extent, linked to the difficulty accountants experience in estimating these values. Many of the studies referenced here have looked at the area of financial instruments. There, it is probably easier to estimate fair values than for most other assets (and liabilities). Thus estimation problems are most likely higher for the type of assets valued in business combinations, leading to a lower usefulness of fair values in those cases. On the other hand, the business combination in itself is a transaction that will increase the reliability of fair value measurements in the acquired company.

As an aside, it is interesting to note that fair values have been used for a long time in some European countries. One example is France, which used fair values in accounting in the 19th Century (Richard, 2004).

6. Minority Interest

After the more general valuation issues, we turn back to literature focusing more specifically on group accounting and business combinations. Minority interest plays a role in the Exposure Draft on IFRS 3, but there is only a limited amount of research done in the area.

Nurnberg (2001) states that in order to obtain conceptual consistency, minority interest should be included in group equity and income. In addition, minority share of goodwill should be included. Thus, this is fully consistent with the view expressed in the Exposure Draft.

Sudarsanam (1996) study the stock market effects of minority interest. The paper shows that the acquiring company obtains a higher return on the acquisition if they acquire less than 100% of the acquired company. This would indicate that business combinations involving minority interest involve a higher support for the asset values that arise in the transaction. This gives further backing the proposals in the Exposure Draft.

7. Accounting Treatment – Effects on Users
Next we turn to the issue of how different accounting treatment of business combinations affects actors involved in the accounting communication. We start by looking at users of accounting, and continue in the next section with producer incentives.

A few studies have looked at the impact of accounting for business combinations on users of financial reporting (Hopkins et al., 2000; Gaertner, 1979; Singleton, 2000). They indicate that users are affected by the choice between purchase and pooling, even under similar economic circumstance. Thus, these studies support the abolition of pooling, and the decision to allow only one method for business combinations.

Other studies have looked at the correlation between reported goodwill and company value, i.e. to what extent investors view goodwill as an economic asset of the firm. Chauvin and Hirschey (1994), Shahwan (2004), and McCarthy and Schneider (1995) all agree that the market perceives goodwill as an important asset. The amortization of this asset over time, however, does not appear to improve financial reporting from an investor perspective. Jennings et al. (2001), Moehrle et al. (2001), and Blackburn Norris and Ayres (2000) all show that the removal of goodwill amortization improves the quality of accounting. This is further supported by Jennings et al. (1996).

Currently, systematic amortization is replaced by impairment testing. Churyk (2005) claims that goodwill impairments provide useful information to the market. Similar findings are provided by Hirschey and Richardson (2003; 2002), but they also show that investors tend to initially underreact to impairments. Schultze (2005) demonstrate that impairments can be caused by different types of events, and they are not always correctly interpreted by financial statement users.

The literature seems to give strong support, both to recent changes in accounting rules, and to those changes proposed in the Exposure Draft to IFRS 3. Goodwill is an important asset, which should be on the balance sheet. Then it is not a disadvantage to include the minority share of goodwill. Further, goodwill should not be amortized, and the impairment testing gives information to users. Further, Henning et al. (2000) show that the market can value components of goodwill, which lends support to the requirements of identifying value in specific assets and liabilities.

8. Accounting Treatment – Producer Incentives

After having looked at the effect on users, we now turn to the other side of the financial reporting communication. What is known about the incentives companies have to account for business combinations in different ways?

Wong and Wong (2001) and Grinyer et al. (1991) indicate that high leverage leads to a lower allocation of purchase price to goodwill. Gore et al. (2000) and Muller (1999) show that UK managers, when they had more choices in how to account for business combinations, tended to choose based on their contracting or market incentives.

Turning to goodwill impairments, Henning et al. (2004) indicate that they are generally not manipulated, but that their timing tends to be stretched to agree with management incentives. Jordan and Clark (2004) test the big bath theory relating to goodwill impairment.
During the time when goodwill amortization was used, the amortization period was determined based on management incentives (Hall, 1993; Henning and Shaw, 2003). This gives strong support to the current rules, i.e. not allowing amortization, but requiring impairment testing.

A different issue is to what extent accounting treatment affects the economics of the business combination per se. Choi and Lee (1991) show that different accounting treatments of business combinations affect merger premia. This is further corroborated in Lee and Choi (1992), and discussed in Nobes and Norton (1997) and Choi and Lee (1997). Further indications of accounting treatment affecting transactions are given in Gregory (2000) and in Ketz and Schams (2004).

Nurnberg and Sweeney (1989) point to a separate potential issue. They claim that financial statement effects of different accounting treatments of business combinations will vary with the economic environment in which the combination takes place. Specifically, effects will differ when asset value tends to rise, compared to when they generally fall.

To summarize, the literature in this section tends to support the current accounting rules. The strong incentives of company management, and the effects on the economics of business combinations, support the efforts at global harmonization of accounting rules, as well as limiting choices available to managers. Further, the removal of goodwill amortization is supported.

9. Accounting Treatment – Other Effects

So far we have seen that the impact of accounting on users and producers has been studied. Other areas of impact include economy-wide effects, and auditing.

Hake (2004) claims that the accounting rules for business combinations enabled the economy-wide asset expansion in the late 1990’s, which later led to very large impairments of goodwill in some companies and industries. He also claims that there is no change in accounting that would prevent future such expansions.

Favere-Marchesi and Embey (2005) indicate that auditor judgment of the need for goodwill impairment is influenced by the auditor/client relationship. The longer this relationship has lasted, the less likely the auditor is to see a need for goodwill impairment.

The suggest changes in the IFRS 3 Exposure Draft does not address the issues raised in these two research papers.

10. International Accounting Diversity

Both Adams et al (1999) and Shoaif and Perez Zaldivar (2005) claim that there is real diversity in accounting treatment of business combinations between IFRS and US GAAP. This lends support to the efforts at harmonization in the exposure draft.
A more difficult issue to resolve is the existence of different views on financial reporting. Thus, even if written rules are harmonized, they may be interpreted in different ways. On the user side, Marton (2005) shows that German users have define high quality accounting differently than US and UK analysts. Nichols and Berger (2002) indicate large differences in the use of accounting between German and US banks.

On the producer side, Bouma and Feenstra (1997) indicate that goodwill treatment in the Netherlands historically was influenced specifically Dutch theory. McCrae and Nilsson (2001) show that the linear dynamics of accounting differ significantly between Sweden and the United States.
Responses to Questions provided

Question 1
The literature suggests that it is advantageous to account for all business combinations using the same accounting treatment.

Question 2
No research was found bearing on this question.

Question 3
Including minority share of goodwill is clearly supported. There are, however, substantial reliability problems involved in the measurement individual assets and liabilities at fair value. It is not clear that the allocation of fair value to individual assets and liabilities add information for accounting users.

Question 4
The literature provides guidance on this.

Question 5
Yes. It is clear that the fair value of the consideration transferred adds substantial reliability in the measurement of individual assets and liabilities (including goodwill) at fair value.

Question 6
No guidance from the literature.

Question 7
Yes. Since the business combination is to be measured at fair value, it is consistent not to include transaction costs as assets.

Question 8
It is theoretically correct and consistent to value all assets and liabilities at fair value. Research shows, however, that there are significant reliability issues in these measurements. Accounting users benefit from information on goodwill, but it is unclear to what extent information on fair values of individual assets and liabilities is useful. Financial statements could be more useful if more of the purchase price was allocated to goodwill.

Question 9
It is reasonable to exclude some assets and liabilities from the fair value requirement. Deferred taxes, for example, are very difficult to measure at fair value. If any change
should be made, it would be to include more assets and liabilities among the exceptions (see also the reply to Question 8).

**Question 10**
The suggested accounting treatment is theoretically correct and consistent. The problem apparent from research is that companies can use this to their own advantage. The accounting treatment could affect economic decisions, in the sense that the timing of decisions is affected by when companies want to realize a gain or a loss. Also, if small percentages of ownership interest are transferred, the reliability of the fair value of the transaction can be questioned. This will lead to challenges for auditors, and for users.

**Question 11**
No guidance from the literature.

**Question 12**
No guidance from the literature.

**Question 13**
No guidance from the literature.

**Question 14**
No guidance from the literature.

**Question 15**
No guidance from the literature.

**Question 16**
There are clearly significant reliability issues in measuring identifiable intangible assets at fair value. Research indicates that there are even reliability issues involved in measuring financial instruments at fair value, leading to less useful financial statement in many circumstances. Intangible assets are certainly even more difficult to value than financial instruments. To some extent this difficulty may be mitigated by the analysis performed in the business combination.

**Question 17**
No guidance from the literature.

**Question 18**
It is evident that the harmonization of valuation rules between the IASB and FASB is beneficial. The remaining disclosure differences are not likely to lower the usefulness of financial reporting.

**Question 19**  
No guidance from the literature.

**Summary**  
We are generally supportive of the proposals in the Exposure Draft. From a theoretical and research perspective the proposals are positive. They lead to a greater theoretical and conceptual consistency in accounting for business combinations.

Our concerns relate to the applicability of the proposals in practice. Empirical research indicates that 1) There are significant reliability issues in the valuation of individual assets and liabilities at fair value and this lack of reliability affect users negatively, and 2) Company incentives do affect both financial reporting choices made by companies, and sometimes even the economic decisions made by companies are affected by accounting treatment.

The concerns suggest that it would be better to allocate more of the fair value to goodwill, rather than to individual assets. Also, the realization of fair value at the time control is obtained could, in some situations, cause non-optimal choices by companies.
References


