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3.4 Capital Markets

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Moderator: Hitoshi Takehara, Waseda University, Japan

M&A GOODWILL ACCOUNTING: “THOSE ARE MY PRINCIPLES, AND IF YOU DO NOT LIKE THEM...”

Humberto R Ribeiro⁹⁷

Abstract – The accounting for business combinations has been a fertile source of controversies, to which the accounting for goodwill generated from Merger & Acquisitions (M&A) has made major contributions. Practitioners continue to suffer amidst industry lobbying versus regulators quarrels, and therefore one can argue that in M&A goodwill accounting: “Those are my principles, and if you do not like them well, I have others”, as Groucho Marx would say.

The replacement of amortisation of purchased goodwill and other intangible assets with definite life by impairment tests continues to raise concerns and therefore remains an accounting issue. Several authors, such as Hayn & Hughes (2006), questioned the superiority of impairment tests over amortisations, while Massoud & Raiborn (2003) suggested that managerial discretion in applying the goodwill impairment tests reduces the quality of reported earnings. Massoud & Raiborn (2003) also argued that SFAS No. 142 creates opportunities for earnings management, particularly in weak economic periods, where companies can undertake a “big bath”, i.e., to recognise big impairment losses in a period when earnings are already negatively affected.

The early 2000’s was characterised by an economic downturn, which has resulted in a recession in the USA in the period between March and November 2001, as defined by the National Bureau of Economic Research (NBER). The dot.com bubble collapse, the September 11 attacks, and the numerous accounting and corporate scandals that resulted in the Sarbanes-Oxley act, are some of the events that could arguably trigger

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the recognition of massive losses following impairment testing in fiscal years 2001 and 2002. Significant impairment losses under SFAS 142 could only occur from fiscal year 2002 onwards, as this standard was first adopted in fiscal year 2002 by most companies. Unsurprisingly, a big bath earnings management has occurred in 2002, as documented in the accounting and financial literature. There is however another fact that may have eased the happening of this “big bath”: the change in the accounting regulation itself, which has diluted the negative impact on corporate earnings due to impairment charges. A big bath earnings management has occurred in 2002, as documented in the accounting and financial literature (see e.g. Jordan & Clark, 2004, 2005). There is however another fact that may have eased the happening of this “big bath”: the change in the accounting regulation itself, which has diluted the negative impact on corporate earnings due to impairment charges. By the means of financial reporting disclosures analysis, this paper examines several aspects of SFAS 142 adoption, namely its significant impact on corporate earnings reported in the USA.

1. Introduction

Before FASB's changes in accounting for business combinations in 2001, the managerial accounting choice preference was clear in the mergers & acquisitions field (M&A): pooling of interests method, regardless its use being conditional to its qualification for a uniting of interests (see e.g. Aboody et al., 2000; Anderson & Louderback III, 1975; Ayers et al., 2000, 2002; Copeland & Wojdak, 1969; Gagnon, 1967; Lys & Vincent, 1995; Nathan, 1988). Management wants to maximize results, and purchase was not a suitable method, as it required goodwill recognition and amortisation, with negative consequences on earnings. Indeed, early studies found that managerial discretion was used in business combinations accounting in order meet

Table 1 SFAS 142 impacts on diluted EPS by industry

	<u>Weighted avg. goodwill and other intang. assets added back (\$ millions)[†]</u>		<u>Average impact on diluted EPS in percentage (pct.)</u>		<u>Weighted avg. impact in pct.[‡]</u>
	<u>2000</u>	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000-01</u>
<u>Consumer Discretionary</u>	<u>42.4</u>	<u>192.7</u>	<u>24.27</u>	<u>30.01</u>	<u>27.18</u>
<u>Consumer Staples</u>	<u>69.7</u>	<u>84.5</u>	<u>10.18</u>	<u>8.82</u>	<u>9.50</u>
<u>Energy</u>	<u>24.6</u>	<u>28.0</u>	<u>11.97</u>	<u>19.43</u>	<u>15.71</u>
<u>Financials</u>	<u>65.4</u>	<u>87.2</u>	<u>18.63</u>	<u>16.30</u>	<u>17.41</u>
<u>Health Care</u>	<u>31.3</u>	<u>39.5</u>	<u>30.22</u>	<u>17.20</u>	<u>23.48</u>
<u>Industrials</u>	<u>94.4</u>	<u>96.5</u>	<u>28.09</u>	<u>34.85</u>	<u>31.53</u>
<u>Information Technology (IT)</u>	<u>87.3</u>	<u>201.6</u>	<u>17.80</u>	<u>66.64</u>	<u>42.48</u>
<u>Materials</u>	<u>40.9</u>	<u>54.3</u>	<u>31.94</u>	<u>19.88</u>	<u>25.74</u>
<u>Telecommunication Services</u>	<u>110.0</u>	<u>134.7</u>	<u>10.43</u>	<u>18.20</u>	<u>14.32</u>
<u>Utilities</u>	<u>23.6</u>	<u>48.1</u>	<u>6.29</u>	<u>12.27</u>	<u>9.29</u>

[†] **Weighted average from purchased goodwill, and other intangible assets than goodwill averages. The number of observations used for computing the goodwill added back average corresponds to the number of observations used for computing the impact on diluted EPS average. The number of observations used for computing the other intangible assets than goodwill average is not shown.**

[‡] **Weighted average for 2000 and 2001's average impacts on diluted EPS.**