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IMPLEMENTATION OF IFRS 3 AND GOODWILL ACCOUNTING

- FROM A FINANCIAL ANALYST'S PERSPECTIVE

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ABSTRACT

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Title: Implementation of IFRS 3 and Goodwill Accounting – From a Financial Analyst's Perspective

Background and Discussion: Few topics are as widely discussed as goodwill and IFRS 3, and several debates address the difficulties of valuation, accounting, allocation, and impairment tests of goodwill. The original intentions of IFRS is that the users of the financial statements must be given enough information about the companies' earnings in order to make an appropriate assessment of the relevance of the goodwill. The financial analysts play an important role on the financial market, since they are frequently viewed as information intermediaries who gather, process, and distribute information for investors. Therefore, their perception of financial statements is of great importance. This study aims to further investigate the implementation of IFRS 3 by the following research question:

- *Is the accounting for goodwill consistent with the purpose of The Conceptual Framework for Financial Reporting?*

Aim of study: The purpose of this paper is to investigate and clarify the financial analysts' view of the implementation of IFRS 3 and the issues concerning allocation of surplus values in corporate acquisitions and the implementation of impairment tests.

Methodology: The study was carried out through interviews with three financial analysts working with major investments as the basis for our empirical data. The interviews were conducted both personally and via telephone, transcribed, and later on analyzed. The study adopts a qualitative character where the results give an indication of similarities and differences between theory and reality.

Results and conclusions: The fact that the accounted value for goodwill is neither perceived as reliable, nor comparable, indicates that the purpose of the Conceptual Framework for Financial Reporting is not met. The results show that the financial analysts devote time and energy trying rather to understand the underlying factors that contribute to the company's earnings than assessing the accounted values for goodwill in the financial reports. However, even though there is a noted problem with today's accounting for goodwill, this has limited impact on the financial analysts we have met. We have found no indicators of the deficiencies regarding accounting for goodwill being so severe that they result in inaccurate evaluations by the financial analysts.

Keywords: Goodwill, IFRS 3, impairment, allocation, acquisition, financial analyst.

Preface

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ABBREVIATIONS

EBITA	Earnings before interest, taxes and amortization
EBITDA	Earnings before interest, taxes, depreciation and amortization
IASB	International Accounting Standards Board
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
RR	Redovisningsrådets rekommendationer
US GAAP	United States Generally Accepted Accounting Principles

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1. INTRODUCTION

The introductory chapter begins with a background description of the chosen topic, followed by a problem discussion leading up to the study's research questions. Furthermore the study's purposes are presented and the boundaries that are made are described.

1.1. BACKGROUND

Since 1st of January 2005, all European listed companies must apply internationally unified accounting standards for consolidated financial statements. The new regulatory framework is called International Financial Reporting Standards (IFRS) and is developed by the independent body International Accounting Standards Board (IASB), which aims for a worldwide harmonization of the accounting principles and an improvement of the quality of financial reporting. It is primarily the requirement for internationally comparable financial statements underlying the IASB's work (Finansinspektionen 2006).

Prior to 2005, purchased and identifiable assets were to be included in the financial statements if proven that they represented future economic benefits and the valuation could be done in a reliable manner. To the extent that the acquired assets did not meet these criteria, the value was instead recorded as goodwill. The application of the regulation stated that acquired goodwill was amortized systematically over its lifetime (RR:1).

The transition to IFRS has resulted in several changes for the companies concerned. One example is IFRS 3, which regulates acquisitions and goodwill. Goodwill arises from acquisitions and is the value that represents the difference between the purchase price and the sum of the acquired company's identifiable net assets (Lönnqvist 2012). IFRS 3 defines goodwill as future economic benefits arising from assets that are not capable of being individually identified and separately recognized. While this rather abstract definition might make it difficult to understand what is behind the amorphous number on many companies' balance sheets, goodwill is usually said to be value-relevant from an external user's perspective when valuating a firm (Wyatt 2008).

According to IFRS 3, goodwill is not to be amortized. Instead, an impairment test is performed once every year. If the value of goodwill has decreased, an impairment of the same amount has to be carried out. Another new feature is that goodwill no longer can contain any identifiable intangible assets; these are instead today to be specified and reported separately (Finansinspektionen 2006).

1.2. DISCUSSION

Goodwill has been subject of much debate, which addresses the difficulties of valuation, accounting, allocation, and impairment tests of goodwill.

A study from a few years back tells us that goodwill in most cases accounts for more than 55% of the total acquisition cost and thus represents a significant value (PwC 2009). But the value on the balance sheet is a forecast; there is a prediction that the asset will generate a market return in the long run (Marton, Lumsden, Pettersson,

Rimmel, & Lundqvist 2010). The characteristics of the asset and the regulatory framework allow considerable room for management's own interpretations when preparing the consolidated financial statements. The regulatory can't cover all possible potential situations businesses are faced with. Therefore, it is up to the management to interpret the rules best way possible. Meanwhile, there is a risk that similar reported transactions will differ between companies if the interpretations vary. In order to present a complete specification of goodwill, the regulatory framework requires additional explanations in words, containing information about the components of goodwill and the uncertainties in the estimates, both when accounting for goodwill and for ongoing assessments of any necessary impairments (Rehnberg 2012). But a recent study shows that only a few of the Swedish companies give an adequate description of the valuation assumptions used for the impairment tests. Also, they fail to inform about the risks in the sensitivity analyzes, such as if and how current market conditions may have affected the tested units (Grant Thornton 2010).

Managements also make assumptions already when deciding whether acquired surplus values should be allocated as goodwill or not. Rehnberg (2012) discusses the companies' incentives to allocate surplus values to goodwill rather than to intangibles. Since goodwill is not, in contrast to intangibles, an asset that is amortized, allocation of surplus values to goodwill implies that the company can maintain their equity high, under the condition that no impairment is carried out. When valuating the necessity of impairments, assumptions regarding fair value adjustments, expected growth and discount rate are also up to managements to predict.

The original intentions with IFRS are that the users of the financial statements must be given enough information about the companies' earnings in order to make an appropriate assessment of the relevance of the goodwill (The Conceptual Framework for Financial Reporting for Financial Reporting 2010). Financial analysts are primary users of financial statements, and their assessments are vital for the information perceived by other stakeholders (Smith 2006). Therefore, their perception of financial statements is of great interest. Analysts' interpretations form the basis for investments made, while their ability to deduce information from the financial reports is crucial for which information benefits the market (Lo & Xu 2008).

1.2.1. Research Question

The above discussion culminates in the following question:

- *Is the accounting for goodwill consistent with the purpose of The Conceptual Framework for Financial Reporting?*

1.3. Aim of study

The purpose of the paper is to investigate and clarify the financial analysts' view of the implementation of IFRS 3 and the issues concerning allocation of surplus values in corporate acquisitions and the implementation of impairment tests. This in order to examine whether or not the accounting for goodwill is in accordance with the purpose of The Conceptual Framework for Financial Reporting. Furthermore, the paper aims to account for analysts' opinions on potential modifications of the current accounting of goodwill.

1.4. Research Limitations

The study is conducted by examining the research problem from a financial analyst's perspective. This implies that several other stakeholders have not been taken into consideration, such as shareholders, creditors, customers, suppliers, competitors, employees, regulators and the community. This paper is further limited to acquired goodwill, and thus does not concern internally generated or negative goodwill. The study is moreover focusing on consolidated financial statements in listed companies that are required to report in accordance with IFRS 3.

1.5. Research Contribution

By responding our research question, we hope to provide further contribution to research and debate on allocation and impairment of goodwill. By connecting our empirical material to previous research in the field of study, together with the Conceptual Framework for Financial Reporting, the study provides insight to the usability of the accounting for goodwill.

2. METHODOLOGY

The following methodology section is intended to provide the reader with an understanding of how the study is conducted. Initially the direction of the research is described, followed by an explanation of the selection that forms the basis of empirical data, and finally a clarification of how the data is collected. Lastly, a critical evaluation of the chosen method is discussed.

2.1. RESEARCH PROCESS AND ORIENTATION

The starting point in the study was to choose a research topic that attracted our attention and initiated speculation. Having considered a variety of options, we eventually decided on problematizing goodwill. We came across the topic in much of the current debate we studied, and we found it practicable and worth pursuing. After establishing what we wanted to find out, we could move on to our research problem and address a specific question in order to drive subsequent research activities. Different types of defined problems are better suited for divergent studies, why the choice of method for the study is based on the problem defined and purpose described for which we have tried to answer and fulfill. While the purpose of the study is to reach a deeper understanding than the fragmented knowledge often obtained by quantitative methodologies, a qualitative approach has been chosen (Patel & Davidson 2003). The empirical data and framework of the study have been developed through orally and written material, together with previous research within the field of study. This approach is best suited for studies of a qualitative character (Lekvall & Wahlbin 2007). The data was handled, analyzed and interpreted to become meaningful for the study.

An important source for research ideas is literature (Ghauri & Grønhaug 2002). The literature has been reviewed during the entire research process in order to produce understanding, frame the problem, identify relevant concepts and position the study. The research problem has also been modified while gradually gaining new insights. Furthermore, the research has lead to new questions, which we to some extent have dealt with in our study, but also chose to exclude and recommend for further studies. While only a few objects have been researched, the study's results give an indication of possible correlations, rather than a generalization of the phenomenon (Rosenqvist & Andrén 2006).

2.2. COLLECTION OF LITERATURE

In order to better formulate and understand the research problem, and to provide a comparison instrument to easier interpret and understand our primary data, secondary data have been collected. Secondary data are information collected by others that we can use to find answers to our questions. Another advantage of using secondary data is the immense time saving. Also, it broadens the base from which conclusions can be drawn, and the reliability of the information and conclusions is significantly enhanced. Yet, there is a risk associated with easily available data. Data with different objectives may not completely fit our problem. In order to minimize this risk, we used our research problem as the starting point for secondary data (Ghauri & Grønhaug 2002).

The following secondary sources have been relevant and used in our study's framework: research articles; journals; dissertations; textbooks and other published material; historical studies; current debate; newspapers and institutes for authorized accountants and other highly qualified professionals. Information has been collected from databases and other catalogues provided by Gothenburg University Library, such as GUNDA, Libris, Google Scholar, FAR Komplett, and Business Source Premier. The search was focused on finding relevant theory within the fields of accounting, financial analysts' perspectives, psychological studies dealing with incentives, allocation of goodwill and impairment testing. We have also referred to research studies that cover the rules that make up the United States Generally Accepted Principles (US GAAP). Despite the fact that there are certain differences between this framework and IFRS, the problems concerning elements of subjective assessments are relevant in both systems, which is why parallels may be drawn between the frameworks (PwC 2012). The following keywords have been most frequently used: goodwill, IFRS 3, impairments, allocation, acquisitions. We have used debate within the field of study primary as a source of inspiration and introduction to our study, rather than as accurate secondary data.

2.3. SELECTION OF RESPONDENTS

Primary data are original data collected by us for the research problem at hand (Ghauri & Grønhaug 2002). In order to fulfill our aim of the study and to identify the financial analysts' view of the implementation of IFRS 3, we have chosen a nonrandom selection limited to three financial analysts. The chosen method is a prerequisite for better overlooking the situation, which demands at least two but preferably several sources to balance each other. The limited selection of respondents diminishes the chance of a representative sample. Meanwhile, few interviews facilitate the process to analyze the data in detail (Jacobsen 2002). Since the aim of the study is to obtain a deeper understanding of financial analysts' perception on the reliability of the financial reports, we consider three interviews a tenable selection. The study further aims to highlight suggestions for improvements of the regulations, which demonstrates the opportunities given for a more detailed and profound understanding of the empirical data.

The few units make the selection of respondents even more important (Jacobsen 2002). The financial analysts we selected for the study have several years of experience working with investments in larger companies, and can therefore assume to possess the insight and knowledge necessary to answer our problem question. This is a matter of the utmost importance since the sample should be oriented based on what information we wish to obtain. We are aware of the fact that the selection limits the number of opinions, and that the answers may slightly have differed if other respondents were chosen. However, we do not believe that this affects the reliability of the study to a point where it can be questioned.

The following section provides a description of the chosen respondents:

Respondent 1

Peter Malmqvist has more than 25 years of experience of the financial sector. He is currently working with analysis, advice and education at *EQR*, including analysis of listed companies and accounting problems regarding these companies, as well as analysis of the macroeconomic trends that are expected to affect the stock market.

Malmqvist further investigates accounting-related problems for *Stockholmsbörsen/Nasdaq OMX,* and is a member of *Rådet för finansiell rapportering, The EFRAG User Panel* and *IASB's Capital Markets Advisory Committee.* In addition, Malmqvist teaches accounting and financial analysis at *Stockholms Universitet*, *Handelshögskolan i Stockholm*, *Institutet för Revisorsutbildning/Far Akademi, IFL/ Handelshögskolan Executive Education, Sveriges Finansanalytikers förening* and *M-gruppen.* Malmqvist has previously been executive analysis manager at *Nordnet Bank*, excecutive manager at *Aragon Fondkomission* and chairman for *Sveriges Finansanalytikers Förening*. His experience further include auditing at the company that today is *Ernst & Young*, as well as corporate finance at *Stockholms fondkommission* and *Sveriges investeringsbank.* Since Malmqvist has extensive knowledge and experience both from the financial sector and the field of accounting, he is a relevant respondent.

Respondent 2
Johan Sjöström has 10 years of share analysis experience, with previous experience from *Atlet* and *Volvo.* He is since 2007 working with portfolio management at *Andra AP-fonden*. The fund is one of northern Europe's largest pension funds, managing 227.3 billion SEK in investments across the world. They have an important mission from the parliament, to maximize returns on the Swedish pension assets in the long run. With concern to the large capital of the fund, which depends on the analysis of Sjöström's assessments, his opinion on the subject of this paper is of great interest.

Respondent 3
Håkan Bohlin has a Ph.D. degree from *Handelshögskolan i Göteborg*. He further has many years of practical experience from acquiring, developing and disposing companies, including public-to-private and private companies' transactions. He is presently responsible for company investments at the investment department at *Sjätte AP- fonden*, which manages pension capital adding up to 18.5 billion SEK. 1990 to 1997, Bohlin worked at *SEB*, having several positions including Head of Credit Analysis. Bohlin currently serves as the Chairman of the Board of *SLS Invest*. His extensive experience from board member in bigger companies has given him good insight in the considerations and decisions made by managements. In regard to Bohlin's wide experience from both theoretical and practical perspectives of the financial sector, his participation gives a relevant contribution to this study.

2.3.1. INTERVIEW TECHNIQUE

One of the interviews was conducted via telephone, while the other two took place at the two respondents' workplaces respectively. All three interviews lasted between 40-60 minutes. The interviews in the study are semi-structured in nature, which means that the interviews have been based on predetermined questions. The interviews were slightly modified in order to best adapt to the interviewed persons' perspectives, and the respondents were given the opportunity to further develop their reasoning with information beyond the main field of study questions (Lekvall & Wahlbin 2007). Even though a semi-structured interview is preferable from several perspectives, it is often inevitable not to use questions to follow up with in order to best ensure finding answers to our research question. However, there is a risk that each interview has taken a different approach as a result of the following questions. In order to provide a justified view of the financial analysts' interpretation of the research problem, a

general background to the field of study was presented, but not further described into detail.

2.4. PROCESSING THE INFORMATION

In order to make sure that no information was overlooked and to ensure that the validity of the interviews is high, each interview has been recorded (Jacobsen 2002). Immediately after each interview, the information has been transcribed to written text in order to match what is verbally expressed. Each respondent was given the opportunity to ensure that we perceived the information correctly. This way, we avoided the information being misinterpreted in any way. Although the transcription process is time-consuming and difficult, and that gestures, accents, body language and other factors seen in colloquial in addition are neglected, the benefits of transcribing the information exceed the drawbacks (Jacobsen 2002). Furthermore, the information was put together and divided into different areas in order to generate a structure for our empirical section. The data is presented in three different areas. First and foremost, the allocation of goodwill is described. Next section covers the impairments for goodwill. Lastly, potential modifications to the accounting for goodwill are presented. In processing the information, it is important to critically evaluate the source's ability to provide accurate information about our research area (Jacobsen 2002).

After processing the information and presenting the empirical data, we proceeded with analyzing the empirical data. The analysis is presented in an identical way as the empirical section. The respondents' answers were compared with theories and previous research within the framework in order to discern similarities and differences. In addition to this, correlations and discrepancies that emerged between the respondents were highlighted, and the section presents a comprehensive analysis that covers the whole research problem. In an attempt to have understanding of the fact that the respondents may tell a modified version of the truth, or that knowledge and experience gaps are not made visible, we have tried to take this into account by cautiously analyzing the empirical data. The concluding remarks have been cautiously drawn because of the limited selection, this due to the fact that qualitative methods are not intended to say something about the general and typical, but rather about the unique and special (Jacobsen 2002).

3. FRAMEWORK

The framework begins with presenting the financial analysts' interest in the financial reports. Thereafter, the basis of the regulatory is presented, with focus on what is relevant for the study, including descriptions of how goodwill and surplus values are to be recognized and allocated, rules for impairments, and incentives that affect the accounting for goodwill. The regulatory is moreover combined with previous research within the selected area that influences the entire framework.

3.1. FINANCIAL ANALYSTS

Analysts use corporate financial statements when evaluating companies' financial position, i.e. determining whether the companies make up good investments or not. Analysts are thus primary users of the financial statements and these should therefore, according to The Conceptual Framework for Financial Reporting (2010), be prepared in a way that supports analysts in their decisions on financial matters.

Analysts can both make judgements concerning their own investments and advice external investors as intermediaries between the market and the actual investors. It is thus often analysts' interpretation of the financial documents that form the basis for the investments made. Other stakeholders' ability to receive accurate financial information thus depends on analysts' interpretations, making these significantly important.

For these interpretations to be correct, analysts need to have access to all information available. Research has however shown that in situations where the management does not consist of the owners of the company, they do not always put stakeholders' interests first. By providing scant information in companies' financial statements, managements can limit both the owners and other stakeholders' insight into the company. Such information gaps between managements and analysts can thus lead to difficulties for investors to make the right decisions (Akerlof 1970).

3.2. THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

IASB intends to develop principle-based, rather than ruled-based, accounting standards. Principle-based standards provide guidance, rather than strict regulation on how the principles should be used in particular situations. It is thus up to each and every company to make professional judgments and interpretations of the rules (Marton et al. 2010).

The Conceptual Framework for Financial Reporting is intended to function as a guidance to reduce alternative accounting interpretations of the principles. It clarifies that the objective of financial statements is to provide information about a reporting entity's financial position and performance and changes in financial position, as it is useful for different users in making decisions on financial matters. The qualitative characteristics are designed specifically to respond to the objectives, and these consist of both fundamental and enhancing characteristics.

3.2.1. Qualitative Characteristics

The two fundamental qualitative characteristics demand that the financial reports should be relevant and faithfully represented. In addition to these, four enchanting characteristics consisting of comparability, verifiability, timeliness and understandability support the objectives for the financial reports to be useful. The demands for the information to be faithful and comparable are two of the characteristics that are particularly important in the discussion regarding goodwill (The Conceptual Framework for Financial Reporting 2010).

Relevant financial information can make a difference in the decisions taken by users. The Conceptual Framework for Financial Reporting (2010) clarifies that the information in the financial statements moreover must be faithfully represented for it to be useful, meaning that the information must be complete, neutral and free from error. This to allow users to rely on the information to properly indicate either what it purports to show or what can reasonably be assumed to show.

By comparing a company’s financial reports between different periods of time, users should be able to see trends in the company's performance and position. The demand for comparability also includes a requirement for users to be able to compare the financial statements between various companies regarding their financial position and performance, and changes in financial position (The Conceptual Framework for Financial Reporting 2010).

Strict comparability would require similar events to be reported in the same manner (Smith 2006). The Financial Framework for Financial Reporting (2010) somehow explains that the comparability requirement includes that users should be informed of which accounting policies have been applied within the preparation of the financial statements. Also, information should be given when changes have been made concerning the policies applied and the effects of such changes. Users will thus be able to identify differences between the accounting principles applied both in the same company between periods and between different companies.

The Conceptual Framework for Financial Reporting (2010) further states that information can be faithfully represented in multiple ways, but that permitting alternative accounting methods for the same economic phenomenon diminishes comparability. However, the Conceptual Framework for Financial Reporting further states that the enhancing qualitative characteristics cannot replace the need for the fundamental characteristics to be fulfilled. Marton (2009) moreover questions whether comparability is truly achieved when the accounting depends on the reporting companies' assessments of how events in the company should be reflected in the financial reports.

3.3. Goodwill

Goodwill can be explained either as synergies arising from acquisitions, intangible assets that do not meet the criteria of being individually identifiable, or other factors (IFRS 3). Gore and Zimmerman (2010) however mean that synergies are the most frequent explanation. In order for Goodwill to be recognized in the balance sheet, it is required to meet the criteria in the definition in IFRS 3. The definition states that goodwill is an asset representing future economic benefits arising from other assets acquired in a business combination, and which can not be individually identified and

separately recognized (IFRS 3). The definition first of all demands goodwill to be considered an asset, meaning a resource that is expected to provide economic benefits for the company in the future, and over which the entity has obtained control as a result of past events (The Conceptual Framework for Financial Reporting 2010). The economic benefits requested in the definition of assets consist of expected cash flows arising from the asset. Since goodwill cannot meet the identification criteria concerning intangible assets it cannot alone provide cash flows (IAS 38). Based on this, it has been discussed whether goodwill is at all appropriate as an independent entry in the balance sheet or if the synergies rather should be represented and measured in the fair value of the underlying assets. Gore and Zimmerman (2010) argue that an asset must be an identifiable resource that exists independently of its valuation. They think therefore that goodwill should not be reported in the balance sheet as an asset.

The demand for control as a result from past events is in IFRS 3 corresponding to the requirement stating that only acquired goodwill is accepted in the financial statements. Internally generated goodwill can thus not be recognized in the balance sheet (IAS 38).

Even though acquired goodwill, according to the current regulation, is allowed to be reported as an asset in the balance sheet, it constitutes what Rehnberg (2012) calls an unstable asset. She divides assets into stable and unstable, meaning that material assets generally can be considered stable. This is based on the fact that these assets can be reliably valued and separately sold. Immaterial assets, including goodwill, do not live up to these attributes and are therefore instead considered unstable.

3.4. Business Combinations

IFRS 3 *Business Combinations* provides guidance on the accounting treatment on the acquisition of a business. Such business combinations are accounted for by applying the acquisition method. This implies that the acquirer needs to classify or designate the identifiable assets acquired, or liabilities assumed, on the basis of the contractual terms, economic conditions, operating or accounting policies and other pertinent conditions, as they exist at the acquisition date (IFRS 3).

The acquisition method aims to distinguish identifiable assets as far as possible, and demands that acquired values should be identified and assigned to the assets to which they originate. Only values corresponding synergies should be identified as goodwill within the financial statements (Gauffin & Nilsson 2011a). To enable this, there are advanced rules for the identification of intangible assets. These imply that identifiable assets are initially valued at their fair values, after which remaining values are assigned to goodwill (IFRS 3). Goodwill is thus measured as the difference between the cost of the acquisition and the net fair value of the identifiable assets and liabilities (IFRS 3).

The purpose of the regulation was that a reduced amount of goodwill would make accounting for goodwill less important (Gauffin & Nilsson 2011a). Goodwill values however still make up significant amounts, and thus have a major impact on the financial statements after the acquisition (PwC 2009, Marton et al. 2010). Based on this, the regulatory discretion has repeatedly been debated in relation to the reliability of accounting. Although the rules to a large extent demand identification of acquired

values, there is scope for managements' own judgments regarding the assets' fair values (Wines, Dagwell & Windsor 2007). Marton et al. (2010) argue that difficulties mainly apply regarding recognition of intangible assets and assumptions that have to be made when estimating fair values. Wines et al. (2007) add that considerable ambiguity and subjectivity because of the discretion are inherent in the requirements. They claim that the discretion contained in the rules opens up for creative accounting, formed after managements' own assessed needs.

In the financial reports, companies should disclose detailed information regarding the cash-generating units to which a significant goodwill value, in relation to the total accounted goodwill amount, is allocated. Information about how much goodwill is distributed to each unit should be provided. In addition, details regarding the valuation method that has been used should be attached, i.e. if it was based on recovery value or value in use. Consequently, different types of information can be obtained depending on the valuation method used (IAS 36).

3.4.1. Cash-generating units

A cash-generating unit is the smallest identifiable group of assets that at a continuing use generates cash inflows that are substantially independent of other assets or groups of assets (IAS 36). Acquired goodwill should be allocated to those cash-generating units, or groups of cash-generating units, immediately by the acquisition (IAS 36). The distribution over the different units should be made taking into account how the synergies from the acquisition are expected to accrue, regardless of how other assets and liabilities are allocated (IAS 36).

Each unit or group of units to which goodwill is allocated should represent the lowest level within the company, at which goodwill is monitored for internal management purposes and not larger than an operating segment (IAS 36). Since goodwill does not independently affect cash flows from other assets, or groups of assets, and since it often contributes to the cash flows in multiple cash-generating units, goodwill must sometimes be allocated to groups of cash-generating units. As a result, the lowest level in a company, at which goodwill is monitored for internal management purposes, sometimes comprises of a number of cash-generating units to which the goodwill relates, but to which it cannot be allocated (IAS 36). The assessment of which assets that are included in the cash-generating units, and to which unit a particular asset belongs, should subsequently be managed in a similar manner, unless a reason for change has occurred (IAS 36).

Although the regulations applied today include extensive requirements and specifications on which detailed information should be enclosed, Hayn and Hughes (2006) note that it is difficult for external parties to see what assumptions have been made regarding the cash-generating units affected by the goodwill value.

3.4.2. Goodwill recognized within Business Combinations

In Gauffin and Nilsson's (2011b) study of how values are allocated within a company combination, it was found that about 95% of the studied business combinations reported goodwill. The distribution of the share of goodwill in relation to intangible assets did however vary widely. 14.8% of the studied acquisitions resulted in 100% of the acquired surplus values reported as goodwill, while the same percentage reported less than 40% goodwill.

In a study by Marton and Rehnberg (2009), remarkable differences were found regarding how much of the intangible assets from a business acquisition that was allocated to goodwill. The differences in the accounts could appear as a consequence of the companies' different situations, but they could also emerge due to principles applied in different ways. Based on similar findings in numerous studies, Marton (2009) however concludes that comparability in accordance with IASB 's definition cannot be deemed attained.

Although IFRS 3 does not provide any explicit exemption from doing actual acquisition analyzes also of smaller acquisitions, Gauffin and Nilsson (2011b) state that from IFRS 3, such an exemption might be possible to interpret concerning one insignificant acquisition, or several acquisitions, which together are considered insignificant, which might be an explanation of the result. Such an interpretation can according to Gauffin and Nilsson (2011b) be made because the regulatory framework clarifies no uniform interpretation of the concept significance, which most likely results in some companies making limited efforts to identify intangible assets for smaller acquisitions. They therefore mean that the purpose of the rules in IFRS 3 are not completely satisfying, since corporate use makes it difficult for analysts and other users to make comparisons.

3.5. Impairments of Goodwill

Assets should generally be impaired when the accounted amount exceeds expected future economic benefits (Marton et al. 2010). Future economic benefits consist of discounted future cash flows, which concerning goodwill are represented by the recoverable amount (IAS 36). The recoverable amount is in IAS 36 defined as the higher of the fair value less selling costs, and the useful value (IAS 36).

According to IFRS 3, no systematic amortization of goodwill is to be done, but instead annual impairment tests are carried out, in accordance with IAS 36 *Impairments of Assets* (IAS 36).

Since goodwill cannot independently generate cash flows, the impairment test implies that the value of each cash-generating unit is tested in its entirety. IAS 36 thus states that goodwill should be impaired when the cash-generating units' accounted amount exceeds its recoverable amount (IAS 36). If the cash flows are expected to decline, the accounted amount may not be justified and must therefore be written down (Marton et al. 2010).

Moreover, the regulatory standard allows previous calculations as a basis for following estimations. If previous figures show that the recoverable amount of an asset is significantly higher than its accounting amount, the company does not need to make new estimates of its recoverable amount unless something has occurred that would eliminate the difference in value.

The recoverable amount is dependent on the discount rate applied. The discount rate should be based on market assessments, taking into account the time value of money and the risk associated with future cash flows. Since there are no transactions of goodwill itself, the discount rate is calculated based on the companies' weighted cost of capital, marginal borrowing rate and other market borrowing rates, with regard to

market risk (Marton et al. 2010). Danin and Hed (2009) observed large variations in the discount rate used by Swedish companies, and no direct systematic division were found for the variations. This, together with similar findings, allows Marton (2009) to conclude that comparability in accordance with IASB's definition cannot be deemed attained.

A study by Grant Thornton (2010) indicated that Swedish companies' goodwill was in 2008 on average 30% of the company's total equity, and only 37 of the 259 researched companies wrote down their goodwill for a total value equal to 1,5% of goodwill. They also found that only a few of the Swedish companies gave an adequate description of the valuation assumptions used for the impairment tests. Also, they failed to inform about the risks in the sensitivity analyzes, such as if and how current market conditions may have affected the tested units. Moreover, the survey showed that a third of the Swedish listed companies lowered its discount rate; meaning that the assessed values increased while the need for impairments was reduced.

Li, Shroff, Venkataraman and Zhang (2011) examined what impact impairments have on businesses. They tested whether the market reacts to news about carried out impairments in a way that affects subsequent years' performance. The overall result is that impairment are leading indicators of a decline in future profitability. The decline is a result of a slow-down of sales, sometimes combined with an increase in operating expenses. The result thus shows that impairments are negatively correlated with average sales growth and operating profits of the subsequent two years. Their study also shows that financial analysts revise their expectations downward when impairments are announced. Their study further shows that in firms with potentially depreciated goodwill, that did not report impairments, market participants however do not revise their original expectations. Overall, the authors find that goodwill impairments convey useful information about the firms' future performance and are viewed by market participants as significantly informative.

3.6. Incentives affecting accounting choices

To determine whether the value is consistent or not is to a large extent dependent on managements' subjective assumptions, since the estimate is based on their own valuations of discounted future cash flows (Marton et al. 2010). The discretion has been both criticized and appreciated in previous debate. Bloom (2009) notes that since impairment tests are calculated based on forecasts, they are inherently unreliable and subject to manipulation. Schultze (2005) further states that you cannot guarantee objectivity within the process and the variables used, since no reliable measures can be derived from the test.

When goodwill is distributed on cash-generating units defined on a lower level, the impairment test includes a detailed measurement of assets and liabilities. By exploiting the discretion within the regulations to identify cash-generating units on higher level, the management is however able to provide a less detailed measure of existing goodwill (Jerman & Manzin 2006).

3.6.1. Optimistic perceptions

It has previously been widely discussed whether corporate managements exploit discretion in an opportunistic manner. Lovallo and Kahneman (2003) argue that

executives tend to make decisions based on delusional optimism rather than on a rational weighting of gains, losses, and probabilities when forecasting the outcomes of risky projects. As a result, managers pursue initiatives that are unlikely to deliver the expected returns. A study by Paulter (2003) reports results that support this perception. In a compilation of studies on acquisitions, he showed that the outcome of acquisitions made was perceived in an exaggerated positive way by managements. When asked whether the acquisitions met their objectives, between 70 and 80% confirmed this. Assuming that success deemed to be satisfied only if the acquisitions resulted in share price appreciation beyond the average for all comparable firms, the proportion of failures however amounted to 75%, which did not correspond with the opinion of managements. With this in mind, adding that the same persons often are responsible for making the key assumptions and assessments to determine the estimation of the recoverable amount, Boyle, Carpenter and Mahoney (2012) say that there is reason to believe that subjectivity playes a prominent role in goodwill impairments.

AbuGhazaleh, Al-Hares and Roberts (2011) conclude however that managements exploit the discretion to convey their expectations about the underlying performance of the company, rather than to act opportunistically. Their overall results show an improvement of the reporting of goodwill depreciation compared to the previously applied amortization method. Yet, Lovallo and Kahneman (2003) believe that the tendency toward optimism is hard to fully avoid and that it is unlikely that companies can, or want to, remove organizational pressures that promote optimism. They further state that one formal way to improve the reliability of forecasts is to introduce an objective forecasting method that counteracts the personal and organizational sources of optimism.

3.6.2. Positive Accounting Theory

Since the recognition of goodwill is a residual from the valuation of intangible assets, it is dependent on the discretionary valuation of these assets. By classifying a large share of the value as goodwill, managers are able to avoid amortization that would otherwise be required.

The positive accounting theory by Watts and Zimmerman (1986) has been described as a theory where all parties are expected to act in accordance to their own interests, meaning that the accounting plays a mediating role between the different stakeholders. Managements are according to the theory assumed to adopt different strategies to achieve their goals and limit the information provided to outsiders (Deegan 2000).

All other circumstances being equal, identifying a great proportion of goodwill leads to higher net income (Marton et al. 2010). Such actions also imply that managements can avoid systematic amortizations, and thus maintain high solidity. According to Hayn and Hughes (2006), there is evidence showing that managements are trying to control the impairments in order to successfully achieve such financial goals.

In addition to this, managements' compensation commonly consists of both a fixed and a variable salary. The variable salary is usually connected to the company's financial objectives and long-term incentives (Volvo Group 2012, Husqvarna Group 2012, SKF 2012, Lundin Petroleum, 2012). Previous accounting research indicates

that future performance is better in companies using compensation systems that are more weighted toward accounting-based pay (Larcker, Richardson & Tuna 2007). It has also been observed that the more CEO monetary compensation that is depended on the company's financial results, the more goodwill is recognized in the acquisition. The explanation to this observation is that managers make discretionary accounting choices opportunistically, since their compensation relies on the company's accounting results. The discretion in IFRS 3 concerning the recognition of goodwill is assumed to influence managers' choice of accounting procedures that takes full advantage of the conditions for reimbursement (Detzen & Zülch 2012).

In accordance with positive accounting theory, the use of bonus systems might cause managements to decide on writing down goodwill during a period when profits are expected to be low. As a result, they manage to avoid impairments during a more positive economic period and can thus achieve their bonus levels (Deegan 2000). When examining bonuses in the year of the acquisition, Detzen and Zülch (2012) argue that the CEOs, who seem to recognize goodwill opportunistically, gains the most because their increase in bonus is significantly higher than those of other CEOs.

3.6.3. CHANGES WITHIN MANAGEMENT

In 2008, Masters-Stout, Constigan and Lovata (2008) completed a study providing evidence that impairments were more frequently made within companies with new CEOs than senior CEOs. The results thus revealed that the regulatory were applied differently in companies with and without new CEOs. The authors of the study state that the predecessor CEOs may be unwilling to impair goodwill associated with their investments. In relation to this, new CEOs have the possibility to have an objective view of previous acquisitions, since impairments will not say anything about the new CEOs ability to make successful acquisitions. They might even want to lower the expectations. The study thus provide some evidence that goodwill impairments are not performed in a similar manner in all companies, meaning that impairments rather are a result of what managements want to display, than a result of past events. The authors conclude that the new regulatory might have opened new doors for manipulation, which might lower transparency of the financial reports.

4. EMPIRICAL DATA

In the following section the study's empirical material that has been gathered through interviews with the chosen respondents is presented. The initial part outlines the financial analysts' view of the allocation of goodwill and excess values, whereafter the impacts impairments have on the respondents' assessments of companies are covered. Lastly, potential modifications of the regulatory are discussed.

4.1. ALLOCATION OF GOODWILL

When Malmqvist observes high goodwill values in the balance sheet, he puts the value in relation to the company's equity and makes the assessment that high goodwill values lead to a higher risk. But what he mainly takes into consideration is the financial performance of the company. A high goodwill value does not necessarily mean that it will affect the share price, but it does generally during a company's economic decline. There is a difficulty in separating the goodwill from the debt ratio and to determine what is a goodwill effect and what is an effect of a weak balance sheet, because high goodwill values usually coincide with high debt ratios. What companies' balance sheets are typically pledged for are investments in bigger acquisitions, and these often generate goodwill. But this has no major impact for the company during a period of growth.

Sjöström has a similar approach and thinks that it is not possible to make an evaluation of the goodwill value in the balance sheet in each individual case. Instead, a high goodwill value becomes relevant when a company is facing economic decline. Only then you can make a judgment about the value and whether this is justified or not. Sjöström further clarifies that if the company would be forced to impair the goodwill value, it can have a huge impact on the equity. This would also have consequences for the solidity.

Bohlin states that when he makes an assessment of a company the analysis is often based upon a cash flow perspective. When measuring a firm's profit using different ratios, such as EBITA[1] and EBITDA[2], goodwill is not included, which is why Bohlin does not take goodwill into account in the assessment. Meanwhile, he would rather choose to invest in a company whose balance sheet comprises safe and easy convertible assets than a high goodwill value. If his appraisal shows that a company's future earnings are unsure, paying a lot for a future, which a high goodwill value denotes, will result in a higher risk. This requires more thoroughly worked out strategies and further investigations of the risks associated with the investment.

Furthermore, Malmqvist finds the allocation to cash generating units as one of the major difficulties within the area, since it is difficult to follow up on the specific acquired company that generated the goodwill value. The allocation of the excess value to or separate from intangible assets is further something that has no basis in reality. While most of the other intangible assets are somehow related to the customers, what is the value without them? There are no models that will tell you

[1] Earnings before interest, taxes and amortization

[2] Earnings before interest, taxes, depreciation and amortization

what the company is worth without their customers. Therefore, the excess value is just a fictive amount regulated by an incomprehensible accounting rule. This makes the forecasts for analysts harder to predict as a result, since the ground for the allocation seldom is described.

Sjöström explains that the process for allocating goodwill looks different in each company, and this has a negative effect on the transparency when comparing companies. As a result, this is more difficult and time-consuming for the analysts, especially when it comes to companies where they plan to make bigger investments. Bohlin says that there are definitely a few companies where he questions whether the accounted goodwill values actually can be defended by reasonable estimates about the acquisitions' future profitability. He further states that the management can argue for allocating as great value as possible to goodwill in order to avoid continuous amortizations of intangible assets. Meanwhile, the problem with allocating the goodwill value is nothing Bohlin considers to a large extent, since this does not control the value of the business. Instead, he must assess what makes the company unique and understand the fundamentals for how they earn money.

4.2. Impairment testing

The respondents all agree on that there is room for subjective appraisals when testing for impairments. Malmqvist consideres the subjectivity to be unlimited, and says that the function of the regulation has collapsed. This is partly due to the extremely low risk-free interest rates in today's society, he explains.

Bohlin also believes that the subjectivity is very big, because what the management bases their assessments on is often some kind of cash flow analysis. And even if Bohlin considers this to be by far the best valuation method, he also highlights the risk of using it. By modifying the rate for economic growth, marginal and cost of capital one can easily make the assumptions needed to justify the goodwill value. And since the only thing everyone knows about the future is that it will never end up the way you predict, it is hard for someone else to question the managements' competence and assessment about the future economic development.

Sjöström says that it is in the nature of things that when estimating a future situation, the projection generally tends to reflect a more optimistic future than the present trend. If one bases these valuations on a discounted future cash flow, there is a risk for larger subjectivity than perhaps originally intended. Furthermore, Sjöström observes some companies with large impairments related to acquisitions, while other companies, despite intensive acquisitions, are without. This might be a result of varying reasoning in different companies. Meanwhile, in the valuation of a company, several factors have to be taken into consideration in the equation, and goodwill is just one, and not the most important one, of them. Moreover, companies in need of impairments generally have problems, and according to Sjöström, these are normally already reflected in the share price.

Bohlin is of the same opinion and states that impairments generally give an indication of something that at some point is not functioning properly. This also sends a signal that worse is yet to come, and Bohlin means that this is one of the reasons for why companies avoid impairments of goodwill.

When it comes to impairments that have been carried out, Bohlin looks at the reasons behind them and then assesses the value of the firm. Malmqvist, on the other hand, is under the impression that a company often shows a positive development after impairments. This is partly a result if a new CEO is appointed, and impairments also show the analysts that the firm can afford to take these costs associated with impairments. It shows the honesty of the management and indicated that the worst problems have now passed. Impairments are consequently an indication of an ascending share price, rather than prospect difficulties within the firm.

Bohlin also discusses the situation where a new CEO is appointed and believes that impairments are dependent on this. If a new CEO initially accounts for higher expenses in order for future results to look better, then this is nothing out of the ordinary and instead shows proof of determination. However, it takes a lot before the CEO who invested in the acquisition agrees on implementations, since one does not want to stand for a bad investment. If impairments are carried out after all, this can be an indication of further needs for impairments. But the bottom line for Bohlin in his valuation of a firm is not mainly with focus on what the financial reports says, but that impairments shows that the management's opinion is that the accounted goodwill is overvalued.

The fact that impairments are not that widely carried out is nothing that concerns either of the respondents. What Bohlin mainly considers is the result goodwill is excluded from, so the value is still not taken into consideration. However, he must make an own assessment, often by interviews with the management. Malmqvist instead includes the goodwill value when analyzing financial ratios, such as return on assets or capital employed, to evaluate whether the firm succeeded in recouping their investment or not. He further states that when it comes to bigger acquisitions, analysts also try to find out what marginal the management is expecting after the investment. If the numbers turn out not to be in line with the objectives, the share price often drops.

4.3. POTENTIAL MODIFICATION

Malmqvist is not satisfied with today's regulatory system, and finds the regulatory framework inadequately constructed. The allocation of goodwill separated from intangible assets is illogical and the tests for impairments do not simplify for analysts to find problems in the companies. If it was possible to encourage the management to more explicitly inform about how they expect the acquired firm to develop two to three years ahead, it would simplify for the analysts when evaluating the managements' competence when it comes to acquisitions, since the information affects future performance.

Malmqvist suggests an alternative method to deal with goodwill that would make the accounting more understandable and possible for analysts to evaluate. Instead of allocating goodwill separate from intangible assets, Malmqvist proposes that the equity in the purchase price allocation should be recognized at the assessed market value. The excess value, consisting of the difference between market-valued equity and the purchase price, is what the company pays over the odds and expects to earn within the next few years. This excess value is further to be recognized together with other intangible assets and written off during a normal economic cycle of five years in order to prevent dividends to be paid out.

What Sjöström, like Malmqvist, wishes for is more evident specifications and disclosures on how the management has applied the regulatory framework. This would both ease the appraisal of how the operating activities have been affected, and also facilitate comparisons between companies. What can be discussed is the fact that if impairments are never carried out, this builds up rather big balance sheet items. And the further it proceeds, the worse it gets. As a result, Sjöström has some sympathy for glancing at the previous regulatory system with systematic amortizations. Yet, in his valuation of companies, he tries to exclude goodwill and instead focus on the essence of the issue. Therefore, he believes that a change of the regulatory framework would not have any implications on his investment decisions.

Sjöström believes that what it all comes down to is a transparency problem based in room for subjective appraisals. He thinks that today's regulatory framework is far from perfect, but this also applies for several other accounting regulations. There is a risk associated with changing the regulatory framework, which implies that one instead creates something rigid. All firms are unique, and it would cause other problems if one tries to narrow the regulatory framework too much. So maybe some kind of flexibility is justified, as long as the rules do not become too complex. Once again, Sjöström emphasizes that analysts focus on the core of the business after all, and goodwill is just a consequence of past sins or good decisions that in the end only will be relevant in a company's economic slowdown.

Bohlin is also under the impression that additional information about the management's prospects about the acquisitions that created the goodwill is necessary, since the best evaluation is still the one made by managements. Bohlin would prefer details about what assumptions the management has made regarding all the items a cash flow analysis implicates: sales growth, operating margin, working capital, investments, taxes and cost of capital. Meanwhile, an external assessor can question the reliability with this type of prospects, since all the assumptions you make about the future will more or less always turn out different. Furthermore, Bohlin discusses the management's incentives for not publish this kind of information. Partly because of the feasibility without excessive costs, but also since the firm does not want to lose competitiveness by disclosing sensitive information.

Like Sjöström, Bohlin further argues, that one can probably narrow the regulatory, but since all companies are unique, this also creates difficulties. And the downside of rules is that people are often likely to go around them. Therefore, detailed regulations are in one aspect good, but it will most probably turn out to be even worse. Furthermore, Bohlin states that if today's regulatory framework would be modified, amortizations are not preferable either, since you should be assumed to have a value that is constantly increasing.

5. ANALYSIS

This chapter analyzes the results of the interviews, based on the framework of the study. It discusses a principle-based accounting standard, the objectives and qualitative characteristics of The Conceptual Framework for Financial Reporting and managements' possibilities to make subjective appraisals. The analysis highlights both the differences and similarities between the respondents, as well as how the results relate to what the literature argues for.

5.1. ALLOCATION OF GOODWILL

The analysts that make up the underlying support for our empirical material mean that the accounted goodwill value in the balance sheet is not interesting as such. The fact that goodwill is not an identifiable resource that exists independently of its valuation can be one of the explanations to why our empirical material shows that no particular interest is paid to this item in the balance sheet prior to investment decisions (Gore & Zimmerman 2010). The division of assets discussed by Rehnberg (2012), also appear to be included in the considerations made by analysts. That Bohlin would rather invest in a company that controls real estate than a company reporting a great amount of goodwill indicates that analysts take into account that goodwill is not possible to reliably evaluate or possible to solely sell (Rehnberg 2012). Since the goodwill value should correspond to future earnings, there is no reliable way for it to be determined. An acquisition of a company with a significant amount of goodwill therefore is an investment in a company that largely consists of an unstable asset, and furthermore an uncertain economic future. The fact that goodwill is such an uncertain asset is problematic in relation to the qualitative characteristics in The Conceptual Framework for Financial Reporting. The information provided to analysts by the accounted goodwill value in the balance sheet cannot represent an actual truth, since it is a result of predictions that are impossible to verify.

Our empirical material further indicates that analysts pay interest to cash flows rather than individual assets. The goodwill item is interesting only when it is significant in comparison to equity. They are important because they present great risks in companies that face economic decline. Potential impairments then would have a major impact, lowering both results and the total value of assets. Even though the goodwill value reported in the balance sheet admittedly has no direct impact on the income statements, the allocation made at the acquisition however has impact on the amortization of immaterial assets. This as a result of amortizations being smaller than they would have been if the surplus values were allocated to these assets. The allocation thus has an indirect impact on financial ratios (Marton et al. 2010). This should be related to the finding that many companies' balance sheets to a great proportion consist of goodwill. When not excluding goodwill in accordance with EBITA and EBITDA, the allocation of goodwill thus has impact on the overall assessment of companies' financial position, even when not taken into particular account.

The empirical material indicates that analysts are aware of the recognized goodwill values being based on subjective judgments, wherefore they do not consider the information received through the financial statements to be sufficient regarding

goodwill. The discussed discretion in the regulation should be observed in the light of the incentives recognized regarding allocation of surplus values within business combinations. The fact that managements, according to Marton et al. (2010), by allocating a large proportion of the surplus values to goodwill, are able to report higher net income provides reasons to question whether such assessments are generally made in a proper manner.

Knowing that the previous accounting research provided by Detzen & Zülch (2012) has indicated that companies with bonus systems, where a significant proportion of the CEOs salary is based on the financial results, generally recognize a large proportion of goodwill, adds additional reason to question what circumstances affect the accounting for goodwill. As such bonus systems are often used, the *Positive Accounting Theory* provides explanations for the analysts' critical view on reported goodwill values (Volvo group 2012, Husqvarna group 2012, SKF 2012, Lundin Petroleum 2012).

Taken into consideration that actual differences have been found regarding how much of the intangible assets from a business acquisition that was allocated to goodwill (Marton & Rehnberg 2009), and moreover that an exception from doing an actual acquisition analysis might be interpreted in the regulation (Gauffin & Nilsson 2011b), it can also be questioned whether the system applied today provides information that is complete, neutral and free from error, i.e. a faithful representation of the circumstances (The Conceptual Framework for Financial Reporting 2010). In regard to the possibility to interpret such an exception from doing an actual acquisition analysis, there is thus a possibility that some companies recognize a greater amount of goodwill than what would have been the case if strict regulations were to be applied at every acquisition. With this in mind, it is uncertain whether reported goodwill values actually provide appropriate information about the potential synergies arising from the acquisition.

Moreover, a problem concerning the demand for comparability can be derived from Sjöström's statement that comparability is complicated with reason to the fact that companies apply the regulatory differently when allocating surplus values. Since it is possible to exploit the discretion differently and therefore account for goodwill in different manners despite the same circumstances, the possibility for comparison is low. For analysts to evaluate companies and determine if goodwill values can be considered acceptable, transparency is important since there is no way to ensure that the rules are applied in a particular way. Transparency is though not available according to the analysts, who mean that scant information is available regarding the allocation of surplus values arising from the acquisition to goodwill and moreover allocation of goodwill into cash-generating units. This can be related to the discussion by Akerlof (1970) concerning managements' tendency to undermine stakeholders' interests by providing scant information. The lack of information thus leads to difficulties in making decisions. The overall conclusion is that the application of the regulatory regarding allocation of goodwill, from an analyst's perception, is not consistent with The Conceptual Framework for Financial Reporting's (2010) requirements for ability to rely on the facts in the income statements and compare different companies. As a result, the application is not consistent with the accounting purpose to support stakeholders in decision-making. The fact that the analysts have more interest in the moneymaking of the companies than single assets however

indicates that allocation of surplus values and allocation of goodwill are of limited relevance for the analysts.

5.2. Impairment testing

Related to goodwill impairments having no impact on cash flows, our material shows that they are not of particular interest to the analysts interviewed. Malmqvist for instance rather looks at the context in which the goodwill values exist, to see what future cash flows can be expected from this context. The empirical material shows that the analysts, to evaluate the context, take different ratios in consideration. When looking at ratios such as return on assets or capital employed, impairments have impact through the direct effect on profit. In such assessments, impairments are of actual importance for the assessments. Many factors are thus considered in the assessments made, and to be able to make well-founded investment decisions it is therefore important that analysts have access to all information available that can be useful (Akerlof 1970).

Even though the regulation provides guidance on what factors should be included when assessing whether the value is consistent or not, research in accordance with the analysts' statements confirms that the discretion is significant (Wines, Dagwell & Windsor 2007). Since it is not possible to estimate future cash flows related to goodwill separated from other assets (IFRS 3), there are great difficulties in assessing whether the acquired goodwill values are enduring. The noted discretion within the regulation therefore highly demands managements' own interpretations of the future. In consensus with the previous research presented, the analysts are aware that many factors might have influence on those interpretations, and subsequently the information provided to analysts.

Bohlin's opinion that impairment tests can be modified to generate the results wanted should be seen in relation to impairment tests, in addition to the estimation of cash flows, also are dependent on the discount rate applied (IAS 36). It should be based on the companies' weighted cost of capital, marginal borrowing rate and other market borrowing rates, with regard to market risk (Marton et al. 2010). Given the research showing that unjustified differences in discount rate (Danin & Hed 2009), and moreover the research proving that the discount rate applied in Swedish companies did not particularly change when the economic climate indicated higher risk (Grant Thornton 2010), there is reason to believe that it depends on managements' assumptions. If so, Bohlin's statement has a substantial ground.

Subjective interpretations are one of the effects of a principles-based regulatory framework. Rather than requiring precise methods for valuating goodwill in a uniform manner, a principle based regulatory allows managements to dynamically recognize goodwill in a way they find give a fair picture of the company. The discretion however represents an opportunity for managements to avoid impairments and moreover acknowledging their poor acquisitions (Masters-Stout, Constigan & Lovata 2008). There are thus apparent incentives for CEOs to avoid impairments that in some cases are justified. The empirical material shows that this is taken into account in the analysts' assessments of the companies, as well as the fact that other incentives might affect the estimations done by managements.

In accordance with Lovallo and Kahneman (2003), the analysts believe that it is common for managements to have an overly optimistic perception of their own acquisitions, which is why forecasts following the acquisitions often indicate improvement. As it is de facto impossible to fully pre-determine whether forecasts are accurate or not, the analysts choose not to put particular faith into the accounted goodwill value, and whether impairments have been done or not. Moreover, research that has been conducted regarding positive accounting theory provides support for the analysts' position regarding this matter to be considered reasonable. In accordance with the theory, managements are expected to act in their own interests, to achieve their goals and limit the information provided to analysts, meaning that there is reason to believe that the information available for analysts is likely to be inadequate. Evidence has been provided regarding managements trying to control impairments to successfully achieve such financial goals (Hayn & Hughes 2006). On the other hand, AbuGhazaleh Al-Hares and Roberts (2011) have provided results showing that goodwill calculations are usually based on the underlying performance of the company, rather than opportunism. These different results however both support the opinion of the analysts; no uniform interpretation is to be made from lack of impairments. If the forecast claims an overly optimistic future, the absence of impairments does not provide analysts true information regarding maintained goodwill value. The empirical material thus supports the previous research saying that non-impairments provide no faithfully represented information about companies' financial position.

The analysts neither find that a uniform interpretation can be made from impairments that have been carried out. Those could indicate financial deterioration, which should be considered to be in order with the regulatory; if the expected economic benefits do no longer correspond to the accounted value, it should be impaired. The fact that Sjöström thinks that impairments indicate corporate problems, is consistent with the research made by Li, Shroff, Venkataraman and Zhang (2010), who conclude that impairments are leading indicators of a future decline in profitability. So far, the accounting meets the purpose of providing faithfully represented information of the companies financial position. The accounting under these circumstances provides correspondence to the regulation's purpose to prevent companies appearing more valuable than they are. However, Malmqvist's statement that carried out impairments might point to future improvements also have valid support, meaning that the purpose of the regulatory is countered. Malmqvist's and Bohlin's opinion that impairments carried out by newly appointed CEOs may indicate improvement, is supported by the study by Masters-Stout, Constigan and Lovata (2008). The authors explain that the fact that impairments occur to a greater extent in companies with newly appointed CEOs, can be a result of one entering with a more objective view of the business. Their conclusions that these impairments also can be a result of the new CEO wanting to lower expectations however show that the carried out impairments are rather a result of what managements want to display, than a result of past events or reasonable expectations.

Given these research results, the fact that the analysts choose not to draw any general conclusions from accounted impairments indicates a deficiency of the accounting for goodwill. The accounting concerning goodwill impairments is not perceived as faithfully represented and comparable by the analysts, meaning that the overall purpose of The Conceptual Framework for Financial Reporting is not supported.

5.3. POTENTIAL MODIFICATION

The fact that the analysts provide a partially diverged opinion of how improvements on the recognition of goodwill could be implemented indicates that the perceived problem does not have a simple solution that is welcomed by all.

Malmqvist's proposal regarding valuation of equity in accordance with market value, whereupon the residual would be amortized, would admittedly entail a uniform processing of goodwill. This would increase the comparability of goodwill in the financial statements. The benefits of such a rule-based system also include managements having clear rules to relate to, meaning that few subjective assessments would be needed and moreover the possibility to be influenced by incentives would be limited. However, it can be questioned whether the accounting then would provide faithfully represented information regarding companies' financial position in accordance with The Conceptual Framework for Financial Reporting. Regarding goodwill that is assumed to represent synergies arising from acquisitions, it can also be questioned whether the method proposed by Malmqvist would provide a fair perception of the individual acquisitions. What is indecisive is whether amortization of the residual value generally equals fair accounting of the synergies. In contrast to, Bohlin thinks that goodwill values should increase over time. His statement implies that amortizations are likely to make goodwill accounting less faithfully represented in favor of the comparability it would provide. If so, Malmqvist's proposition would improve an enhancing qualitative characteristic at the expense of a fundamental qualitative characteristic, which would lead to a deterioration of usefulness (The Conceptual Framework for Financial Reporting 2010).

The fact that the analysts agree that further information would facilitate their efforts to evaluate companies indicate that more extensive requirements in the regulatory would improve the accounting for goodwill in accordance with the purpose of The Conceptual Framework for Financial Reporting. Given the information gap discussed Akerlof (1970), i.e. the fact that managements tend to keep certain information to themselves, a stricter demand for further information could contribute to a limitation of managements' advantage. Further information could thus improve the quality of the financial statements (The Conceptual Framework for Financial Reporting 2010). It would admittedly not mean that the circumstances taken into consideration when making the statements would be objective and thus contribute to a more faithful representation in the financial statements. Nor does further information overcome the fact that the accounting for goodwill in accordance with the regulatory today is not perceived comparable. The comparability is naturally perceived inferior when companies to some extent depend on subjective assessments.

A principle-based regulatory however offers opportunities for managements to dynamically adjust the accounting to the facts of the particular company and thus provide a more fair picture of its financial position. Requiring detailed descriptions of the information taken into consideration could provide increased opportunities for analysts to evaluate the validity of the information, which despite the deficiency for comparability and faithfully representation could be considered an improvement of the accounting quality regarding goodwill.

6. Concluding Remarks

Based on the study's empirical material, together with the analysis, the concluding remarks that can be stated from these data are presented in the following chapter. While the purpose of the conclusion is to answer the research question, this is its primary content. Also presented are suggestions for future research.

6.1. Conclusion

The purpose of this paper is to investigate whether or not the accounting for goodwill is in accordance with the purpose of The Conceptual Framework for Financial Reporting. What this paper conducts is a comprehensive analysis of analysts' perceptions on goodwill accounting. Our results show that the analysts are aware of the issues concerning allocation and impairments of goodwill, wherefore they perceive the information in the financial statements inadequate. The fact that both allocation of goodwill and impairment tests to a large extent are based on projections made my managements implies that the accounted values are impossible to verify. This enables managements to follow incentives in order to present a view of the company that is actually based on irrational assumptions.

Considering the subjective appraisals underlying the accounting for goodwill, the financial analysts have limited faith in the accounted goodwill values in the financial reports. The respondents have different perceptions of whether goodwill should be included when assessing companies' future performance or not. One perception is that instead of finding support from the accounting for goodwill, they rather try to get around the calculations and instead focus on understanding the underlying financial situation. Another view is to include goodwill when analyzing financial ratios in order to evaluate whether the firm succeeded in recouping their investment or not.

As further result of underlying subjective assumptions and incentives for presenting an optimistic view of the company, previous research has shown that different methods are used to allocate goodwill and test for impairments. Accounting based on subjective appraisals therefore limits the opportunity to compare accounted values for goodwill between companies. The fact that the financial analysts confirm previous research regarding incentives also suggests that the accounted values are not faithfully representative.

The paper further aims to account for analysts' opinions of potential modifications of the current accounting for goodwill. Modifications towards a system with market-valued equity and continuous amortizations on the excess value may facilitate the comparability, but everyone does not appreciate this proposal. The system would not contribute with an accurate view of the synergies created by the acquisition. According to The Conceptual Framework for Financial Reporting, the qualitative characteristic *faithful representation* is of greater importance than *comparability*. Since comparability is an enhancing qualitative characteristic, it cannot make the information useful if it is not also faithfully represented.

The fact that the accounted value for goodwill is neither perceived as reliable, nor comparable, indicates that the purpose of the Conceptual Framework for Financial

Reporting is not met. The results admittedly show that the financial analysts devote time and energy trying rather to understand the underlying factors that contribute to the company's earnings than assessing the accounted values for goodwill in the financial reports. However, even though there is a noted problem with today's accounting for goodwill, this has limited impacts on the financial analysts we have met. We have found no indicators of the deficiencies regarding accounting for goodwill being so severe that they result in inaccurate evaluations by the financial analysts.

6.2. Suggestions for future research

Along the process, we found varying interesting aspects that we chose to exclude from our study, since they are beyond the scope of our limitations. However, they may inspire others to conduct a similar future research with a different approach. Our suggestion is to conduct the same type of qualitatively oriented study from a creditor's perspective. This is interesting since creditors have a different perspective as stakeholders than financial analysts when assessing a company. The financial analysts we have examined generally evaluate prospect for growth in a firm, and put great emphasis on assessing how future earnings will look like. Creditors, however, assess the risks associated with the loan agreement and devote the majority of the appraisal evaluating the borrower's repayment ability. With this direction of the study, it would be interesting to see how the results differ from our study.

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8. APPENDIX

8.1. INTERVIEW TEMPLATE

- When assessing the risk in a prospective investment, what is your opinion on high goodwill values in a company?
- To what extent do you consider the accounted value of goodwill in the annual reports to be credible?
- What is your view on managements' possibilities to make subjective appraisals when:
    - Allocating surplus values from business combinations to, or distinct from, intangible assets?
    - Allocating goodwill to cash generating units?
    - Annually testing for impairments?
- What are the consequences of your investment assessment if a company has made impairments in recent years?
- Research show that impairments of goodwill have not been made to any great extent in recent years. What impacts does this have on your investment assessments?
- How would you, as a user of financial statements, prefer the accounting for goodwill to be modified in order to get a better view of the company's financial condition?