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A qualitative study of IFRS 3
- Allocation of the net acquisition cost

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Preface

Initially the authors would like to thank the tutors, Pernilla Lundqvist and Jan Marton, for guidance and complementary assistance in the work with this report. The authors also wish to thank all objectors for their constructive and helpful feedback. Furthermore, all the respondents are worth special thanks for their valuable contributions. Pernilla Rehnberg, Deloitte Gothenburg, deserves a special mention since she helped the authors during the initial phase with this report.

Gothenburg, 2007-06-01

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Abstract

Degree thesis, business economics, School of Business, Economics and Law at the University of Gothenburg.
Spring 2007

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Title: A qualitative study of IFRS 3 - *Allocation of the net acquisition cost*

Background and Problematization: Increased globalization has created a larger demand for a harmonization within accounting areas. The new accountancy standard, which is called IFRS, emphasizes that companies, to a larger extent than before in Sweden, make their own judgements of economic events. With the introduction of the IFRS standards, the purpose is to show the true and fair value of a company. One of the most significant changes has taken place within the regulation that concerns Business combinations which is denominated the IFRS 3 standard. When the IFRS 3 was introduced, companies quoted on the Swedish stock market became obliged to specify, to a larger extent than before, the acquired intangible assets instead of accounting them as part of goodwill.

A problem seen from the external shareholder's decision-making point of view is the fact that different entities allocate various amounts and percentages of the total acquisition cost. While some entities assign the total acquisition cost as goodwill, others assign only a small fraction of the total amount.

Purpose: The purpose of this report has been to examine how companies reasoned and effected the allocation of the net acquisition cost between different assets and goodwill when acquiring companies. An additional purpose has been to illuminate how companies' allocation of acquisition cost affects analysts' opinions of the accounting information.

Choice of method: The authors have conducted a qualitative study based on interviews. An investigation on how three selected companies reasoned when applying the IFRS 3 rules concerning allocation of acquisition cost between assets has been effected.

Result and conclusions: There are several different reasons why allocation of acquisition cost differs between companies. Synergy effects, the acquirers' size relative to the acquiree and result management incentives are all possible explanations as to why differences exist.

Regarding the second question, the authors have come to the conclusion that analysts are far more interested in cash flows and as a result, effects from the transition on analysts have been quite limited.

Further research within the area: The authors claim that it would be interesting to conduct a similar study within a few years to see the effects of time and experience regarding the application of the IFRS 3 regulation. Also, an investigation on the effects of a future recession on contingent impairments would be of interest.

Word description

EC	The European community
IAS	The International Accounting Standards are standards set by IASB.
IASB	The International Accounting Standards Board is an independent and private organisation setting standards within accountancy.
IASC	The International Accounting Standards Committee was founded in June 1973 in London and replaced by the International Accounting Standards Board (IASB) on April 1, 2001. It was responsible for developing the International Accounting Standards and promoting the use and application of these standards.
IFRS	The International Financing Reporting Standard, are a set of accounting standards. Currently they are issued by the International Accounting Standards Board (IASB). Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS).
IFRS 3	This standard handles business combinations such as acquisitions and how to handle the item goodwill.
RR 1:00	This is the prior regulation that handled business combinations in Swedish quoted companies.

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1. Introduction

This chapter is supposed to give the reader an introduction to the subject and its problems. Further on the purpose of this report is explained.

1.1 Background

Two separate traditions concerning accounting have dominated since companies started using accounting as an economic tool. The Anglo-Saxon- and the continental traditions are two main accounting paths which differ considerably from each other. These traditions differ due to the fact that from a historical perspective, the parties interested in accounting information have requested different ways to shape and form the economic data presented. The Anglo-Saxon tradition advocates relevance and openness due to the fact that the scattered mass of shareholders has been the primary subject for external accounting information. The continental tradition, in which Sweden is included, has primarily prioritised reliable and conservative accounting with, for example, accounting at acquisition values instead of market values.¹ This is because of the fact that external interested parties such as banks and financiers have been the primary subjects for external accounting information and therefore have demanded a conservative, trustworthy, accounting.

Large companies do often not only compete on their national markets anymore. In order to survive it is often necessary to compete internationally.² One major contributing cause for this is the increased globalisation, trade and larger investment flows that circle worldwide. Together with this, mergers and acquisitions of companies have become more common on all financial markets. Increased globalization has created a larger demand for a harmonization within accounting areas.

With the objective of facilitating the comparison of accounting information between companies from different countries, a common set of rules and regulations within the EC has been produced. This harmonisation process of the above mentioned traditions is being affected by the accounting organisation IASB, which originally was called IASC. The IASB has produced a common framework, IFRS, introduced within the EC 1 January 2005. IFRS emphasizes that companies, to a larger extent than before in Sweden, should make their own judgements of economic events. That means a large change to quoted Swedish companies which historically have been influenced by a strong regulation. Reliability was a cornerstone in Swedish accounting before and since more emphasis is now put on relevance and subjective judgements, some of the former reliability is lost, which is a problem with the newly introduced regulation.³

With the introduction of the IFRS standards, the purpose is to show the fair value of a company by forcing companies to produce a more relevant accounting.⁴ Hand in hand with this relevant accounting come subjective judgements which are not always reliable. The objective is to give better information to the users of accounting information so they can make decisions based on this better information. It has therefore been of interest to investigate if better information for users actually has been produced in accounting after the introduction of IFRS.

¹ D´Arcy, A 2001, Ball, R 1995

² Sudarsanam, P. S 1995

³ Smith, D 2006

⁴ Ibid

Great changes have taken place regarding accounting in companies with origin from countries historically advocating the continental tradition and reliable, conservative, accounting. One of the most significant changes has taken place within the regulation that concerns Business combinations, when one company acquires another company. The regulation is called the IFRS 3 standard. When the IFRS 3 was introduced in 2005 it meant significant changes to the way accounting of combines should be produced.⁵ At the event of a business combination the acquiring company must affect a PPA, *purchase price allocation*, an allocation and subjective valuation of the total purchase price between the acquired companys' identified assets, liabilities, contingent liabilities and possible residual goodwill item. In other words, with the introduction of IFRS 3, companies quoted on the Swedish stock market are obliged to specify, to a larger extent than before, the acquired intangible assets instead of accounting them as part of goodwill. Thus, the demands are now considerably higher, for a more transparent specification of intangible assets, which often are difficult to value, partly due to their specificity.⁶ At the event of a business combination, subjective judgements now play a larger role in the purchase price allocation process. Even though it might be difficult to allocate the acquisition cost between different items, the economic events are better reflected with the new regulation.⁷

In addition, an identified goodwill item is now handled differently. Goodwill should not, as before, be an item for periodical amortization anymore, but tested for impairment on at least a yearly basis.⁸ The abolition of forced goodwill amortization and introduction of more judgement in goodwill valuation is likely to be beneficial in financial reporting.⁹

Gauffin and Nilsson (2006) statistically describe the acquisitions that took place during the first year under the new regulations. In their survey the allocation of the acquisition cost between tangible, intangible assets and goodwill differed considerably between different acquiring companies. Many reasons might exist as to why the allocation between assets and goodwill differs to such a large extent at the event of acquisition. For example, when introducing new rules an uncertainty arises, of how to produce the accounting. Possible ways out might be to elaborate the accounting in an institutional way, that is using old methods independently of the new changes, or to simply imitate other producers of accounting.¹⁰ The fact that goodwill is not subject to continuous amortizations anymore leads to direct effects on the accounting. Goodwill is treated as an asset with a non-defined length of time and amortizations therefore do not affect the profit and earning statement in a continuous way. This leads to the question whether some companies might use this to their own advantage.

Furthermore, the varying character and industry connection of a company might be explanations as to why different entities allocate the acquisition cost differently between items. Despite this fact, it is interesting to look deeper into the reasons why some companies have assigned a considerably larger part of the acquisition cost as goodwill then have others. The authors have selected three companies that effected business combinations during 2005 and that assigned considerably different goodwill as part of the total acquisition costs.

⁵ Marton, J & Falkman, P 2007

⁶ Marton, J 2007

⁷ Davis, M 2005

⁸ IFRS 3

⁹ Wyatt, A 2005

¹⁰ Rehnberg, P 2007

1.2 Problematization

A problem seen from the external shareholder's decision-making point of view is the fact that different entities allocate various amounts and percentages of the total acquisition cost.

The average net acquisition cost in quoted Swedish companies consisted of 52 percent goodwill in 2005.¹¹ The residual half of the acquisition cost was equally divided between specified tangible and intangible assets.¹² It is, however, of great importance to mention that the diffusion round the average amount in this survey is large. Thus, the extremes differ considerably. While some entities assign the total acquisition cost as goodwill, others assign only a small fraction of the total amount. There are significant difficulties for practitioners to allocate value between goodwill and other identifiable intangible assets.¹³ Accordingly, it has been interesting to examine how the companies reasoned and decided when allocating the acquisition cost. Therefore, the authors have tried to find an answer to why the allocation differs so radically between the selected companies. Seen from an external perspective it has been of interest to investigate different shareholders' opinions regarding this matter.

The authors have investigated the following questions:

How do companies reason when applying the part of IFRS 3 that concerns allocation of the acquisition cost between different assets at the event of business combinations?

How, and to what extent, do companies' allocations of acquisition costs affect users, in the form of analysts, opinions of the accounting information?

1.3 Purpose

The purpose of this report has been to examine how companies reasoned and effected the allocation of the net acquisition cost between different assets and goodwill when acquiring companies. An additional purpose has been to illuminate how companies' allocation of acquisition cost affects analysts' opinions of the accounting information.

1.4 Delimitations

When analyzing allocation of net acquisition cost between assets and goodwill, other matters become interesting as well. Other standards, such as IAS 16 concerning tangible assets and IAS 38 concerning intangible assets, come into play when analyzing business combinations. The authors have nevertheless decided to limit the focus of this report to be exclusively on the parts of the IFRS 3 standard that concern allocation of acquisition cost.

To be able to conduct a study on the subject the authors limited the study to cover three companies that effected acquisitions in 2005. This has given the authors the opportunity to illuminate their applications of the part of IFRS 3 that concerns allocation of acquisition cost in a better way than would have been the case if using a larger number of companies in the study. Furthermore, three analysts in their role as users of accounting information, and four auditors have been objects of investigation.

1.5 Further research

The authors claim that it would be interesting to conduct a similar study within a few years to see the effects of time and experience regarding the application of the IFRS 3 regulation since

¹¹Gauffin, B & Nilsson, S-A 2006

¹² Ibid

¹³Dunse et al 2004

it is newly introduced. Also, an investigation on the effects of a future recession on contingent impairments would be of interest. The procedures used when recognising and assigning values to tangible and intangible assets would also have been highly interesting to look deeper into and may be a subject for further studies.

2. Method

This chapter explains which type of method has been used when producing this report. Reasons and arguments why the selected method has been used are also presented.

2.1 Choice of method

Two main types of methods are at our disposal when choosing how to approach empirical data: quantitative and qualitative methods. The authors have decided to conduct a qualitative study based on interviews to be able to achieve the purpose of this report in an optimal way. An investigation on how three selected companies reasoned when applying the IFRS 3 rules concerning allocation of acquisition cost between assets has been carried out. In order to be able to produce a thorough case study of three companies' approaches regarding the matter.

The authors have analysed three quoted companies' applications of IFRS – business combinations. A qualitative method is applied when data is collected to gain an understanding of a problem.¹⁴ The authors claim that answers obtained in interviews increase the understanding in this matter. Except from the fact that interaction between the interviewer and respondent arises, an interview facilitates the interpretation and understanding of a respondents' opinion. One of the advantages of interviews compared to other qualitative methods is the possibility of explaining the questions so the respondent really understands the meaning of the questions.¹⁵

A disadvantage of a qualitative method of choice is the fact that it is time-consuming. The amount of time used for each object is high which has led to a low selection of respondents. A quantitative method of choice would in this report not be relevant since the analyzed data is not numeric or measured in statistical or quantitative terms.

2.2 Primary and secondary data

The report and its results are based on data of both primary and secondary character. If data is collected by the authors and has not been published before, it is called primary data¹⁶ whereas it is called secondary data if collected by other persons, authors or institutions.¹⁷ The primary data used has been interviews with selected companies, auditing firms and analysts while the secondary data used has been in form of annual reports of the companies, published articles and literature within the subject.

Secondary data has, apart from annual reports and literature, also been used in the form of an article published by Gauffin and Nilsson (2006). They performed the analysis quantitatively, based on statistics that in turn was the basis for further analyses and assumptions.

2.2.1 Selection of primary and secondary data

In order to be able to give a broad picture of the problems, interviews with three categories of respondents have been carried out. Different shareholders in the form of corporate representatives from three selected companies, analysts covering these companies and auditors were interviewed with the objective of illuminating the subject from different perspectives.

¹⁴ Andersen, I 1998

¹⁵ Andersson, B-E 2001

¹⁶ Halvorsen, K 1992

¹⁷ Andersen, I 1998

Analysts have been interviewed to obtain answers to questions concerning what importance they put on companies' application of IFRS 3, when analyzing accounting information. Analysts have been elected to serve as users of company specific accounting information.

Audit firms were contacted to gain their expert opinion within the subject. Especially since it is presumable that information from the selected companies might be biased to their own advantage, it has been of great interest to obtain the more objective view of auditors on the matter. The authors have interviewed auditors also with the objective of illuminating the information received in the interviews with the companies and analysts from another angle. The authors are of the opinion that interviews maybe should have been conducted in a specific order regarding types of respondents. The fact that the respondents' schedules have determined the interview appointments has, however, limited these possibilities.

The selected companies were contacted in order to receive their view of the effected allocation of acquisition cost, and in order to reduce possible partiality, the authors have interviewed auditors from the four largest audit firms on the market.

Secondary data used in this report is based on figures from the prior study published by Gauffin and Nilsson. Other secondary data used has been collected from annual reports as well as from articles, literature and the Internet. On the Internet, the authors have used the search engine Google™ and the following key words: "IFRS", "IFRS 3" and "IAS". The sources used were selected from a reliability perspective. The authors are of the opinion that audit firms and analysts have a higher reliability than for example prior produced theses. However, it is not the fact that respondents are employed at recognized firms that increase their reliability. The increased reliability is due to the respondents' actual knowledge-base and logical reasoning.

2.3 Selection of Respondents

Three companies, Meda, Hexagon and Stora Enso, were selected for an investigation regarding their different allocation of acquisition cost at the event of business combinations in 2005. The selection was based on their largely differing goodwill as part of the total acquisition costs. The fact that these three companies realized three of the ten largest acquisitions made by Swedish quoted companies in 2005 gives this report a larger substance than would have been the case if using three smaller acquisitions. A negative aspect is that information is not always provided by the larger companies. The interviews with representatives from the selected companies were made with persons closely connected to the subject of this report. To a large extent the authors have tried to get hold of people involved in the acquisitions in question to get the best information.

The risk that the selected companies might withhold or bias information to make themselves look better is obvious. This risk exists in both the financial reports and during interviews. It has been necessary to complement the partiality of these respondents with interviews carried out with independent parties.¹⁸ Interviews have been carried out with analysts and auditors to obtain their objective opinions and further information on company specific facts that the companies themselves, for some reasons, might bias or not want to reveal at all.

The authors have wanted to investigate how the introduction of IFRS 3 has affected analysts in their practice. The authors made interviews with three analysts specialized in covering one

¹⁸ Esaiasson, P et al 2007

each of the companies investigated in the report. These analysts are assumed to possess great expert knowledge within the area or at least better knowledge than analysts in general. The objective has been to gain their opinion as specialists on these companies and to achieve a better understanding concerning to what extent the recent changes have affected the analysts. The authors have seen analysts as the natural choice when it comes to external users of accounting. The authors have supposed that, in comparison with for example institutional investors, analysts mediate more objective opinions since they do not have any personal incentives which might be the case with representatives from institutional investors owning shares in different companies and industries.

There is a disadvantage in using analysts as respondents and that is the fact that they base their assumptions and prognoses on different grounds, which gives different results. In the questions the authors have intended to ask, the risk that this disadvantage affects the answers is quite low since elaborations of any prognosis have not been the objective with effected interviews.

Auditing firms have been contacted to obtain the perspective of an independent, objective part. The main reason that auditors have been selected as respondents is the fact that they possess great expert knowledge within the subject. Because of the fact that the IFRS 3 regulation is almost exclusively applied to quoted companies, the authors decided to carry out interviews with the largest firms since they audit quoted companies and therefore supposedly possess great knowledge within the area. All four responding auditors are experts in the IFRS 3 area and work on a continuous basis with the problems that are dealt with in this report. This, with the fact that all respondents are employed at the major four auditing firms, Ernst & Young, Deloitte, KPMG and PWC Öhrlings, gives this report a large amount of reliability.

2.3.1 Loss of respondents

Unfortunately one of the selected companies, Meda, denied the authors an interview due to the fact that the respondent did not want to share company specific information. The information arrived too late for the authors to be able to substitute Meda for another company. Since Meda has been subject of discussion in all the interviews, the authors have decided to present the chapter concerning Meda despite their choice to not take part in an interview.

2.4 The interviews

The interviews were made in two different ways: in person and over the telephone. The authors have let the respondents decide themselves whether to carry out a personal or phone interview since the respondents usually have a limited amount of time. In the cases when respondents located outside the area of Gothenburg have been interviewed, phone interviews have been made. This due is of the fact that the transportation need therefore has been eliminated.

The authors have used a list of quite general questions regarding the subject when conducting the interviews. The advantage of this type of questions is that a discussion arises and the respondents' answers become more thorough. A disadvantage though might be that the respondents do not answer the questions specifically enough. The list of questions has been somewhat adjusted depending on from which of the three categories the respondent came. All interviews within each specific respondent category circled round the same set of questions since the comparability of opinions therefore became larger.

The authors have wanted their role to be secondary since the interviewer must not pressure the interviewed person for information he does not want to give.¹⁹ Instead, the authors have wanted the opinions of the respondents to come forward by letting them speak quite freely on the subject. In qualitative interviews standardized questions are not used to avoid that the researcher directs the interview.²⁰ The authors have sent the questions in advance in the cases the respondents have required so.

The use of personal and phone interviews instead of, for example, mailing question forms, gives the information gathering a better reliability, since the misunderstanding factor that exists in written material is limited. One disadvantage of written interviews is the fact that the respondents' answers depend on the informants' ability to formulate the questions asked. Another disadvantage is related to the fact that the respondents do not have the possibility to get impressions such as the intonation of the informant, which often helps to clarify uncertainty.²¹ These are reasons why the authors have used personal and phone interviews. Also, since the authors have a limited amount of time at their disposal in producing this report, personal interviews is a better procedure since the answer to a question arrives immediately.

2.5 Method problems

2.5.1 Reliability

It is of great importance that the collected information is reliable. To increase the reliability in information obtained from interviews; both the authors have been present at the interviews. Answers to questions have been noted to facilitate the compilation of obtained material after the interviews.

On the question regarding how the authors are able to use the sources of information, a large part of the answer depends on what reliability the source has.²² In the cases where selected companies have been interviewed, the reliability should be questioned since the information obtained might be biased in some direction. When auditors have been interviewed the reliability is very high since all respondents are assumed to possess expert knowledge within the IFRS 3 area and are employed at the four most recognized audit firms.

Since all respondents are employed in large companies which they, at least not to a great extent own themselves, both personal and company-based values and opinions form their answers to questions. The authors have had in mind that the answers given in the interviews might be influenced in certain ways, depending on which values the respondent represents.

Regarding the interviews with auditors, it is of importance to mention that they might have been in contact with these companies in the past and therefore have a biased opinion of them and their behaviour. The same scenario applies to the analysts but in that case no doubt exists whether they have been in contact with the companies since they are covering them continuously.

If great accord between, from each other independent, sources exists, the reliability of the sources is strengthened.²³ The use of independent auditors as sources should therefore support

¹⁹ Holme, I.M & Solvang, B.K 1997

²⁰ Ibid

²¹ Svenningsson, et al 2003

²² Holme, I.M & Solvang, B.K 1997

²³ Ibid

the reliability of this report since their personal opinions have had considerable accord with each other. As the work with this report has progressed by, and as interviews have been carried out, the authors have gradually obtained greater knowledge and understanding of the theme regarding the IFRS 3 standard and allocation of net acquisition cost between assets and goodwill. This greater knowledge might have affected the authors' behaviour during interviews. In such cases the validity has increased since the authors then have had gradually better possibilities to understand the respondents and produce attendant questions.

Since the authors in some cases released the questions in advance, the answers made in these interviews might have been adjusted in some direction to suit the respondent better than an impulsive answer would have done. On the other hand, sending the questions in advance might affect the respondents' answers positively since they then have had more time to reflect.

There is a disadvantage in using tape recorders when personal interviews are conducted, due to the fact that the respondents sometimes get uncomfortable with the situation.²⁴ In the cases the authors have realized interviews in person, no tape recording has been used since the authors did not want to put the respondents under pressure by the fact that a tape was running. That is the positive side while the negative side is the risk that some information might be lost.

A low number of respondents decreases the statistical reliability. When interviews are conducted the answers given are often formulated differently between respondents, which indicates that it is hard to compare the answers even when the questionnaire is similar.²⁵

The authors have based this report on figures from the prior study by Gauffin and Nilsson. Since Gauffin and Nilsson are employed at the auditing firm Deloitte, their study should be seen as objective but secondary information must always be seen critically and not be taken for granted.

2.5.2 Validity

High reliability is a necessary condition for obtaining high validity in the research. However, high reliability is not a guarantee for validity.²⁶ The validity depends on what the authors investigate and whether this is dissected in the problem.²⁷ The authors have discovered great differences between the three selected companies, regarding what part of the total acquisition cost these companies have allocated to goodwill. Therefore, the validity should be high since the subject of the investigation is highly relevant when the authors investigate what reasons might exist for these differences.

The relevance, which lies as a secondary expression under validity, reveals how relevant the used empirical selection is to the problem.²⁸ Independent auditors with large knowledge within the area of investigation have been interviewed to get answers to the authors' questions at issue. One of the questions in this report regards analysts' opinions on the IFRS 3 subject and for that purpose analysts have also been interviewed. Therefore, the authors find the relevance and validity considerable.

²⁴ Repstad, P 1999

²⁵ Holme, I 1997

²⁶ Dahmström, K. 2000

²⁷ Holme, I.M & Solvang, B.K 1997

²⁸ Andersen, I 1998

To obtain validity in the collected information the questions have been designed in a subject-specific way which simultaneously gives space for discussion and a better basis for information.

2.6 Empirical data and analysis

In this report the authors have collected qualitative data which has been summarized and analyzed in order to draw conclusions. The purpose of the empirical data is to illuminate the respondents' answers. The authors have decided that a thematic compilation gives the greatest, pedagogic understanding of the questions asked. The authors have divided the empirical and analysis chapters concerning respondents. Results from the interviews with the selected companies are presented separately and are followed by results from interviews with auditors and analysts together. This has been done in order to create a better understanding regarding the analyzed companies. The data related to the companies is thereby logically not confused with the rest.

The empirical data is divided in subject specific areas. When the authors compiled the reference frame and the empirical data an analysis of the material was made, which is described in a conclusion chapter.

3. Reference frame

The purpose of this chapter is to facilitate a greater understanding within the subject matter of this report. The authors present existing theories and framework related to the topic area.

3.1 Mergers and Acquisitions

Two different main perspective theories exist, from which an acquisition can be viewed. This chapter explains practical motives for an acquisition.

If a company has a strong connection to its owners, most decisions made by the executive group are made with the intention of maximizing shareholder value. The net present value method is often used as a motive for an acquisition. If the summarized future cash flow that is gained from an acquisition exceeds the company's capital cost, the company should proceed with the acquisition. In mergers, this criterion is fulfilled when the created added value exceeds the cost of the merger.²⁹

Today, company owners are often separated from the control of the company. The relation is known as the agent- principal theory. Company executives do not always act from what is best for the shareholders, the cost paid for this is known as an agent cost. This cost is a loss for the shareholder.³⁰

One reason for executives not acting according to their owners' interest is the fact that separate private interests are involved when it comes to decision making. The pursuit of increased power, which is connected with a larger company, is a recognized phenomenon. Sometimes the potential value added, seen from a shareholder's perspective, is overvalued.³¹ It can also be hard to identify the company executives' real motive behind an acquisition, both before and after the purchase. It is hard to prove that the acquisition was a failure since executives may twist the reasons for why the purchase was a failure.³²

3.1.2 Effects of synergism

One major effect which emerges from an acquisition is synergy effects. When companies work better together as one unit instead of two, synergies have had a positive effect. Another angle of view is the fact that an acquisition makes the companies stronger together, a phenomenon which can be explained by the equation $1+1=3$.³³ The most common effects of synergism wanted in acquisitions are described in this chapter.

A motive for an acquisition, but also one basic condition for success, is that the company acquired has *complementing resources* which the purchasing company can share. A resource can be all sorts of assets, competence, information, knowledge etcetera. Complementing resources exist when two companies can share each other's resources in order to enhance their common competitive advantage on the market.³⁴

Studies of mergers and acquisitions that have been made indicate that added shareholder value is higher if the companies have complementing resources instead of more resources in

²⁹ Sudarsanam, P. S 1995

³⁰ Ibid

³¹ Gaughan, P. A 1991

³² Ibid

³³ Ibid

³⁴ Hitt, M.A, et al 2001

common. An explanation for this is the fact that similar resources are related to similar strategies and threats on a company basis. When an acquisition is made, the strategies and threats are often unchanged, while quantity in production often is affected.³⁵

One reason why mergers and acquisitions exist is due to the *economies of scale* that can be obtained. This can be held as a motive when mass producing companies acquire companies. Larger scale operations can, for example, decrease the marginal cost of a specific product when the fixed costs are divided in more entities. Economies of scale also emerge when product technology or large purchases cause discount prices.³⁶

A company might be very successful within a specific business area. With a merger or acquisition there is a possibility to apply this strength to a business area that is related. If this is applicable, the company has taken advantage of *economies of scope*, which creates synergies and a more profitable company. Strengths that easily are applicable are competence or large distribution channels.³⁷

Companies with a broad experience within *management and corporate governance* have better conditions to success in business. If a company has a lack of management competence it can gain profit from being acquired because it will gain access to experience in management. This acquisition argument is relevant in cases when small, fast growing, companies expand more than what can be handled by the management. Management matters concerning knowledge within marketing and distribution networks are two examples.³⁸

Many companies effect acquisitions for varying reasons. When doing so, these should be reflected in the accounting in an adequate way. There are different frameworks of accounting regulation for companies to follow. IASB produce the regulation standards IAS and IFRS that are mandatory for quoted Swedish companies to follow.

3.2 IFRS and prior regulations

Until January 1 2005 accounting in companies quoted on the Swedish stock exchange was regulated primarily by recommendations of the Swedish Financial Accounting Standards Council³⁹. Business combination was controlled by RR 1:00 Entity Accounting, in which mergers and acquisitions constitute a substantial part.

According to RR 1:00, acquisitions have to be accounted primarily with the purchasing method. Besides the main regulation to use the purchasing method, Swedish accounting legislation⁴⁰ allows the capital share method in case the business of the subsidiary essentially differs from the business of the entity in total.⁴¹ By using the purchasing method, an acquisition made by an acquirer is seen as a transaction, by which the parent company acquires the assets and liabilities of the subsidiary. From the moment in which the acquirer obtains decisive influence over the net assets of the subsidiary and its activities, the acquirer shall include the profits, losses, assets and liabilities of the purchased company within its own accountancy.⁴²

³⁵ Hitt, M.A, et al 2001

³⁶ Case, K.E et al 1999

³⁷ Hitt, M.A, et al 2001

³⁸ Gaughan, P. A 1991

³⁹ In Swedish: Redovisningsrådet

⁴⁰ In Swedish: Årsredovisningslagen

⁴¹ P 29. RR 1:00, FAR 2007

⁴² P 32. RR 1:00, FAR 2007

In case of a merger, the pooling method is compulsory. A merger is accounted differently from an acquisition in the sense that no purchase from a third part is activated. The consequence is that no purchasing values are calculated as in the case of an acquisition.⁴³

According to RR 1:00, goodwill shall be amortised systematically over the using period. The using period reflects the period within which the company anticipates economic benefits from the goodwill item.⁴⁴ A linear amortisation method shall be used if no convincing reasons exist for using any other method.⁴⁵ The amortised amount shall be accounted as a cost in the profit-loss statement for every period.⁴⁶

3.2.1 IFRS – Introduction

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.⁴⁷ IFRS advocate that the accounting information and economic reporting in companies follow certain standards with the objective of achieving a *true and fair view*. Thus, IFRS emphasize four principal qualitative characteristics for the reporting to attain. These characteristics are *understandability*, *relevance*, *reliability* and *comparability* and these are further explained in this chapter.

An essential quality of the information provided in financial statements is that the *users understand* it. Users are assumed to have reasonable knowledge of business and accounting. However, information about complex matters that are included in financial statements shall not be excluded merely because of its difficulty level since the relevance for the economic decision-making by users is high.⁴⁸

Information provided in financial statements must be *relevant* to the decision-making needs of users. When the information helps users evaluate past, present or future events it has the quality of relevance.⁴⁹ Past performance and financial position is often used for predicting future financial development. The ability to make predictions is enhanced by the way information is displayed. For example, if abnormal and infrequent items of income or expense are separately disclosed, the predictive value of the income statement is enhanced.⁵⁰

Information must be *reliable* to be of use. The balance sheet should faithfully show the transactions and other events to be reliable. In certain cases it is so difficult to measure the financial effects of items that many companies would not recognise them. Such a case is the generation of internal goodwill, which is almost impossible to measure reliably.⁵¹

Users must be able to *compare* financial statements of a company through time to identify trends in its financial position and performance. Users should also be able to evaluate the relative financial position of different companies. Therefore, the financial information must be consistent over time within a company as well as between companies. Due to this fact, users

⁴³ P 84. RR 1:00, FAR 2007

⁴⁴ P 54. RR 1:00, FAR 2007

⁴⁵ P 55. RR 1:00, FAR 2007

⁴⁶ P 56. RR 1:00, FAR 2007

⁴⁷ IFRS Framework P 24

⁴⁸ IFRS Framework P 25

⁴⁹ IFRS Framework P 26

⁵⁰ IFRS Framework P 28

⁵¹ IFRS Framework P 31-34

must understand and recognise changes in, for example the introduction of IFRS, accounting policies. It is of importance that the financial statements correspond with preceding periods.⁵²

A balance between the above mentioned qualitative characteristics is necessary. Professional judgement should be used to obtain the most optimal balance between them. The IFRS framework does not deal directly with the term “true and fair view” but by applying the principal qualitative characteristics and appropriate accounting standards, financial statements are normally understood as true and fair.⁵³

3.2.2 Goodwill

In the event of a business combination the acquirer, the purchasing company, pays the owners of the acquiree, the company being acquired, a sum of money or a combination of money and stocks or other assets. Goodwill accrues when the amount paid for the business exceeds the value of the identified tangible and intangible assets minus the liabilities. The goodwill represents an expectation of future excessive monetary benefits and shall be defined as an asset in the balance sheet. The goodwill is valuated at the day of purchase and thereafter an impairment test will be conducted every year to ascertain if a write-down is needed.

IASB define goodwill as “future economic benefits arising from assets that are not capable of being individually identified and separately recognised”.⁵⁴ Several reasons exist for a company to pay an amount in excess of the book value when acquiring a company. A well-known brand, established relations with customers or suppliers and highly competitive personnel are all examples of desirable intangible assets. These, along with the fact that positive effects of synergy and large scale operations often occur are strong reasons for an acquirer to pay an overvalue, or price premium, in the event of acquisition. Hence, the excessive amount of money the acquirer pays that is not possible to allocate on specific items in the balance sheet, is referred to as goodwill.

3.2.3 Effects of IFRS compared to classic Swedish accounting

The international standardisation of accounting policies and regulation has to a large extent taken place within the frame of IASB, formerly IASC. Their standards are based on the Anglo-Saxon tradition which historically has had investors as their main target group for the financial statements. This is because of the greater spread of external stock ownership in the Anglo-Saxon area compared to the continental hemisphere. These external owners demand a relevant, true and fair view of the actual state of the entity since they lack full control of internal company specific information as basis for their investing decisions.⁵⁵

With the introduction of IFRS in Swedish accounting quoted companies are obliged to follow its regulations to take part in the harmonisation of European accounting.

3.2.4 The introduction of IFRS 3

In 2004 IASB introduced the new standard IFRS 3 for accounting business combinations. 2005 was the first year in which financial reports of companies quoted on the Swedish stock market were developed under the new regulation. Great changes in comparison with preceding Swedish regulations are introduced in IFRS 3. Except for the fact that the requirements for information have been augmented, the authors further on will give a short summary of the most important changes with the introduction of IFRS 3.

⁵² IFRS Framework P 39-42

⁵³ IFRS Framework P 45-46

⁵⁴ IFRS 3, appendix A defined terms

⁵⁵ Smith, D 2006

IASB define a business combination as the bringing together of separate businesses into one reporting entity. The objective of IFRS 3 is to guide the financial reporting of an entity when undertaking a business combination. In all business combinations the purchase method shall be used. The acquirer shall at the event of a business combination recognise the acquirer's identifiable assets, liabilities and contingent liabilities at their fair values at the date of acquisition. Goodwill should be recognised and subsequently tested for impairment rather than amortised.⁵⁶

The compulsory method used in business combinations is the *purchase method*. Thus, the pooling method which, according to IAS 22/RR 1:00, was permitted in some extraordinary cases, is now prohibited. As a consequence of this IFRS demand that a buyer always is identified in a business combination. The buyer is the one that obtains decisive influence over the merged business. The time of acquisition is, as before, defined as the time the acquirer obtains real control over the purchased company.⁵⁷

Along with the IFRS 3 introduction, the already existing standards IAS 36 and IAS 38 concerning impairments and intangible assets were updated. This update has brought with it that more intangible assets should be identified and changed regulation regarding impairments.

The acquirer should at the time of the purchase show and *specify the values* of all identifiable assets, liabilities and contingent liabilities of the acquiree at their actual values in the balance sheet. Further on, IFRS demand that more identifiable intangible assets are accounted for as separate items, that is not as part of goodwill as before. These *disclosure requirements* of intangible assets are considerably larger with the introduction of IFRS 3 than before. Once all the assets are identified and disclosed at their fair value the excessive amount is assigned as goodwill. For an example of how the disclosures are effected at an acquisition see appendix 7:1.

Goodwill is no longer an item for amortisation as was the procedure before. The value of goodwill should rather be *tested for impairment* on, at least, a yearly basis according to the regulation in the IAS 36 Impairment test. If an indication arises, of falling value of goodwill between two balance dates, an impairment test should be pursued.

If the fair value of the purchased net assets exceeds the acquisition cost of the stocks' *negative goodwill* accrue. In case of such a situation, the acquirer must review the value of the net assets. If that value still exceeds the price paid for the stocks, the exceeding amount should immediately be accounted for as an income in the combine balance sheet.

Provisions for *restructuring costs* are only permitted to be accounted for if there, at the time of acquisition exists an obligation on behalf of the acquiree to fulfil the terms of IAS 37 Provisions.

3.2.5 Allocation of acquisition cost

At the time of acquisition the acquirer should allocate the acquisition cost between the acquired identifiable assets, liabilities and contingent liabilities by accounting these at actual

⁵⁶ IFRS 3

⁵⁷ IFRS 3

value. That is required whether if these items have been recognised in the acquiree's balance sheet or not. For further understanding see appendix 7.1.

If it is presumable that an asset will give future economic benefits and the actual value may be calculated reliably, it should appear in the acquisition balance sheet. Regarding liabilities the demands are similar; if regulation of a liability is presumable and the consequence is an outflow of resources, the liability should appear in the accounts. Contingent liabilities of which it is possible to calculate an actual value should also appear in the accounts.⁵⁸

Intangible assets that satisfy the recognition criteria of IAS 38 should appear in the acquisition balance sheet. The criteria are that the assets are identifiable, controlled by the company and that they are expected to generate future economic benefits. Furthermore, the actual value must be possible to calculate. Since the requirement of future benefits always is fulfilled in case of an acquisition, IFRS demands that the identifiable intangible assets should be accounted separately from goodwill.

The fact that identifiable intangible assets should be accounted for in the acquisition balance sheet means that more intangible assets probably will be identified in comparison with current accounting. For example, research or development projects in the acquired business should be accounted for in the balance sheet whether or not the costs of the project have been recognised in the acquiree's balance sheet before. An intangible asset satisfies the relevant recognition criteria if it may be sold, licensed, let out or exchanged. The asset might also fulfil the requirements if it is an asset in the sense of a contractual or legal right.⁵⁹

IASB lists items that meet the definition of an intangible asset in an appendix to IFRS 3. Among the items are market-related intangible assets within which trademarks, trade names, collective marks and certification marks are included. Internet domain names and unique design in the form of colours, shapes or package designs also meet the definition.

Customer-related intangible assets that meet the definition are customer lists, order or production backlogs, customer contracts and the related customer relationships.

Artistic-related and contract-based intangible assets should also be accounted for in the acquisition balance sheet. Within the first category the following are included: plays, operas, ballets, books, newspapers, musical works, advertising jingles and audiovisual material such as films, music videos and television programmes. Within the contract-based assets are among other things licensing, royalty, lease and franchise agreements, operating and broadcasting rights and service contracts. The last category regarding technology-based intangible assets include patented, unpatented technology and databases together with trade secrets such as secret formulas, processes or recipes.⁶⁰

⁵⁸ IFRS 3

⁵⁹ IFRS 3

⁶⁰ IFRS 3, Illustrative examples

4. Empirical data

In this chapter the authors present the collected data. First, the selected companies and their respective acquisitions are introduced briefly, which is followed by the results from interviews with corporate representatives. Furthermore, information obtained from auditors and analysts is presented.

4.1 Analyzed companies

4.1.1 Stora Enso

Stora Enso is an integrated paper, packaging and forest products company. Their core business areas are production of publication and fine paper, packaging board and wood products. Stora Enso's sales totalled approximately MSEK 132,000 in 2006 and the company has approximately 44 000 employees in more than 40 countries. Stora Enso mainly serves business-to-business customers through its own global sales and marketing network. Customers include, among others, publishers, printing houses and merchants, as well as the packaging, joinery and construction industries.⁶¹

4.1.1.1 The acquisition

The acquisition of the German company Schneidersöhne was the largest single acquisition made by Stora Enso in 2005. The figures below concern this company.

The acquisition was accounted for by using the purchase method under which Stora Enso allocated the total purchase price to assets and liabilities based on their fair values. Fair values of intangibles were calculated according to accepted valuation methodologies and have been based on independent appraisal. The fair value determination of the customer contracts and related customer relationships has been derived from customer turnover rates and expected cash flow generation for customers' remaining estimated life time. Company and product trade marks were recognized as intangible assets separate from goodwill, their values being derived from discounted cash flow analysis using the relief from royalty method.⁶²

Goodwill represents estimated synergies to be achieved as a result of better efficiency in logistical flows, merging of overlapping operations and better purchase conditions from external suppliers, and in existing Stora Enso units expected to benefit through increased sales volumes.⁶³ Details of the Schneidersöhne acquisition, along with figures for the entire Group are shown in the appendix 7.2.

According to Stora Enso, goodwill is synergies expected in an acquisition, calculated as the part of the purchase price above the acquired company's net-worth. These overvalues are compared to the discounted cash flow from expected synergies and is allocated to those units that are expected to gain from the acquired synergies. When evaluated cash flows are lower than estimated, this result in an impairment test.

4.1.1.2 Interview with Stora Enso

The authors have made a phone interview with Jussi Siitonen who has worked over 15 years within the Stora Enso combine. Siitonen started as a chief accountant at one of Stora Enso's subsidiaries and is now senior vice president and chief accounting officer at the head office in

⁶¹ <http://www.storaenso.com/>

⁶² *ibid*

⁶³ *ibid*

Finland. Siitonen has extensive experience from being involved in several acquisitions since the year of 2000.

Regarding the IFRS 3 standard, Siitonen finds the new regulation less difficult to follow than the prior regulation since “they have clarified certain items and how these shall be classified at an acquisition. However, the disclosure requirements are much more detailed which is a negative aspects from the practitioner’s perspective.” Siitonen continues by saying that for users, such as analysts and investors, the new standards are considerably better because of the recently mentioned drawback for producers of accounting information.

The transition phase from the prior regulation to the IFRS 3 has passed “quite smoothly” according to Siitonen. Siitonen returns to the disclosure requirements when he refers to what the largest challenges of the introduction of IFRS 3 were for Stora Enso. Siitonen adds that he does not think that the valuation process is difficult but it might be difficult to do everything by the book and disclose for example business secrets, since the disclosure requirements are “quite nasty”.

Regarding Stora Enso’s way of handling acquisitions, Siitonen argues that it has not changed to a large extent since they already before the introduction of IFRS 3 calculated with surplus values on assets. Siitonen adds that IFRS 3 and IAS 36 should be seen as a whole and since IAS 36 regarding impairment tests has been updated, it has put larger pressure on the companies concerning fair value allocations between assets. Since the impairment tests of goodwill have become more demanding, Stora Enso “also prepare for the worst scenario at the time of acquisition to see if any potential risk for impairment the following year exists.”

On the question of whether the new regulation shows a company’s true and fair values better or worse, Siitonen means that an “artificial accounting” has been created. Siitonen’s opinion is that “it forces you to actually create certain assets and in certain businesses, especially in the forest industry it is very difficult, even impossible in some cases, to specify those certain intangibles.” It is difficult to value for example customer-bases since the forest industry is based on competitive prices and the fact that customers are changing from one supplier to another means that you do not have any constant customer bases to value.

Concerning the comparability between companies using the IFRS 3, Siitonen means that it is considerably better than with prior regulation, given that they actually follow the IFRS 3. Siitonen means that since the disclosure requirements are so detailed, a user that really spends time on going through them, will get a very transparent view of the state between companies. Siitonen says that he has certain doubts about whether other companies apply the regulation to the same extent as Stora Enso. He does, though, understand why they do not apply the rules and once again refers to the demanding disclosure requirements.

Regarding the goodwill item, Stora Enso have detailed methods of control that its assigned values are adequate. Cash flow calculations are made to see the net present values of expected future synergies. “If they are far away from the goodwill that we are presenting, we have an error somewhere”, Siitonen continues.

Siitonen says that Stora Enso’s different business areas are managed based on ROCE, return on capital employed. To motivate the different divisions to follow the new regulation profoundly, Stora Enso has effected some changes in internal business management. Earlier, this capital included working fixed capital but excluded goodwill from the amount. “Earlier,

all divisions wanted to present their acquired surpluses as goodwill since that improved the ROCE figures. Now Stora Enso have changed the internal reporting so that also goodwill is included in this employed capital.” Siitonen means that this fact has changed the attitude considerably since, now, “they like to and try to allocate all surplus values of depreciable assets so they can get rid of those surplus values. They do not want to show so much goodwill anymore.” The authors have assumed that by *they*, Siitonen refers to his co-workers in business controlling positions.

In all acquisitions made by Stora Enso after the introduction of IFRS 3 and the update of IAS 36, external valuation experts have been used to assign the proper value of purchased assets. Approximations of, among other items, the acquired customer-base are made regarding how long they expect to retain the customers. Stora Enso concentrates these approximations on the key customers and makes calculations of present value of future cash flows. On the question regarding how many years the customer base should be depreciated, Stora Enso have used different depreciation periods depending on “how long time it takes to generate that kind of customer relationship and make it profitable.” Concerning other intangible assets, Siitonen means that since Stora Enso is a large manufacturing industry it does not possess as many intangible assets as other businesses.

Siitonen means that the new regulation gives fewer opportunities for result management than earlier standards since you earlier could assign considerably more of the purchase price to goodwill and thereby improve your operating profit figures. Siitonen says that you nowadays have to prove your goodwill and show that it really belongs to your balance sheet. He adds that the only way you can manipulate results is with the depreciation period determination.

Siitonen is of the opinion that “huge differences” exist between forest related industries and for example pharmaceutical businesses regarding the difficulty to allocate the acquisition cost between purchased assets. Siitonen means that the latter possess a larger amount of different intangible assets. As a consequence, in the acquisitions effected by Stora Enso, a minor part of the acquisition cost has consisted of intangibles. Businesses in, for example, the pharmaceutical industry are based on certain innovations and Siitonen argues that it in those cases it should actually be easier to allocate the goodwill between certain items. Siitonen means that goodwill that is motivated by synergies might be justified but concerning goodwill that is merely assigned without synergy creation by, for example, overlapping functions Siitonen doubts the reliability.

4.1.2. Hexagon

Hexagon is a global technology group specialized in measurement technologies, polymers and key components. In 2006 the Group’s turnover totalled MSEK 13,469. Hexagon has 8,170 employees in 30 countries.⁶⁴

Hexagon is organized in mainly two business areas; Hexagon Measurement Technologies and Hexagon Polymers. The business area Hexagon Measurement Technologies is a supplier of systems for measuring objects and gaining access to substantial metrology data in one, two or three dimensions. The Hexagon Polymers business area is specialized in producing rubber compounds and gaskets, as well as plastic and rubber-based wheels. According to the company, the most significant effects of the adoption of IFRS relate to corporate acquisitions, which are treated in IFRS 3.⁶⁵

⁶⁴ <http://www.hexagon.com>

⁶⁵ <http://www.hexagon.com>

4.1.2.1 The acquisition

Hexagon's acquisition of Leica Geosystems was their largest specific acquisition made in 2005. The transaction generates synergies through Leica Geosystems and Hexagon gaining access to each others' technologies. A technology transfer between market segments will enhance Hexagon's customer offering. Leica Geosystem's customers within air-borne and land-based metrology will gain access to Hexagon's experience of multidimensional metrology. Hexagon's customers can access Leica Geosystem's product portfolio. The acquisition also creates operational synergies through larger platforms for research and development, component procurement, aftermarket services and software development. The operational synergies confer Hexagon with the possibility of attaining higher margins and competitive advantages.⁶⁶

In the annual report the goodwill amount is not specified on the different reasons for its existence. The explanations for goodwill are synergies and this is mentioned several times. Hexagon further divide the goodwill between business areas that they calculate will gain from the acquisitions. For figures and amounts concerning Hexagon's acquisitions in 2005, see appendix 7.3.

4.1.2.2 Interview with Hexagon

The authors made an interview over the telephone with Anders Gervide, Hexagon. His position within the firm is group controller which means that he is in charge of the formal part of economic reporting. Before he joined Hexagon, Anders Gervide worked within the steel industry for over 25 years.

Gervide means that the investigation and analysis at the event of an acquisition are more profound with the newly introduced IFRS 3 regulation than before. When Hexagon acquired Leica Geosystems a very extensive work and acquisition analysis was the basis for decisions. The new regulation, though, does not affect the operations in a significant way, according to Gervide but he means that a consequence of the IFRS 3 introduction is that the price level of acquisitions has risen.

The valuation process is generally a procedure of very subjective assumptions and judgements according to Gervide. In Hexagon's case they do not use any valuation experts. Instead, they effect these matters on their own. What Hexagon technically do is that they estimate the value of the acquired entities' assets to the cash flow they generated in the acquired company.

Gervide is of the opinion that a large matter of uncertainty exists when valuing a firm and he especially mentions two subjects that affect the valuation process significantly; inventories and, even more, the customer lists. The inventory that mandatorily should be accounted for at its market value reduced by sales cost is hard to value but according to Gervide the customer lists is an even more difficult matter. It is difficult to assign valuations to customer lists since "Estimations are made, on what time period they will stay with you or when they will disappear as your customers."

Gervide adds that every company obviously wants the best return on investment and profit per share as possible. "Companies, I say companies not us, of course want the lowest possible amortizations" says Anders Gervide. "To Hexagon this is not a significant question since the largest part of the acquisition cost of Leica Geosystems was the brand, which however will not be amortized."

⁶⁶ Hexagon, annual report 2005

On the question of whether it is possible to affect the amortization to be as low as possible, Gervide answers that it absolutely is. It is possible, to some extent, to adjust the discount factors and the way you look at the customer lists and turnover. For example, you are allowed to estimate the time period that you will gain from existing customers between 1 and 10 years. “That gives you a very large range to play within.” The authors asked Gervide to give his opinion on whether the accounting information is reliable when it is possible to effect such adjustments. His answer was that the reliability is tolerable.

In comparison with the prior regulations there are both pros and cons, according to Gervide. He means that the fact that goodwill is not anymore required to be amortized over 20 years affects Hexagon’s profits positively. For a company of the size of Hexagon this does not “matter that much”. However, there is a positive effect and Gervide sees the new regulation as better in that respect. Gervide says that to Hexagon there have been no problems with understandability. Still he is of the opinion that to smaller companies it might be difficult since they “not only have difficulties of understanding the standard but they also cannot afford to hire external valuation and counselling.”

Whether the view is more true and fair with the introduction of IFRS 3 or not, Gervide says that the fact that you specify the separate parts makes “it a bit misleading”. “For example regarding the inventories that you have to buy as if you bought them Over The Counter, when you actually buy the company as a whole and not the parts of it.” This specification of the different parts is also the main reason why the price level of acquisitions has risen recently, Gervide adds.

In the future, we will see impairment tests that lead to down-writings, Gervide says. “Companies that do not achieve estimated synergisms and profitability will have to effect write-downs.” However, Gervide says, this is not a change compared to prior rules since these impairment tests were conducted even then with the exception that they were conducted on a more irregular basis than is required now.

4.1.3 Meda

Meda is a European specialty pharma company. Meda covers Europe via its subsidiaries in approximately 20 European countries and has 1000 employees in marketing and sales. In 2006 the annual turnover was approximately MSEK 5,300. Specialisation occurs within marketing and market-adapted product development. A main part of its product flow is also created through partnerships, in-licensing, and product acquisitions. Meda's prioritised therapy areas are cardiology, dermatology, respiratory, pain and inflammation, and gastroenterology.⁶⁷

4.1.3.1 The acquisition

The acquisition of Viatris, which was the largest acquisition made in 2005, gave Meda direct access to established marketing organisations, resulting in time and money savings. The companies complement each other with respect to products and geographic regions. There are product synergies, because Meda’s products now can be simultaneously sold on several markets, while Meda’s organisation may also sell Viatris’ products in the Nordic countries.

Meda has no production facilities, all manufacturing is subcontracted. Viatris has modern production facilities for inhalation products and tablet production. Viatris also has capacity for

⁶⁷ <http://www.meda.com>

pharmaceutical development, which will enhance the value of the existing portfolio. The objective for the integration of the two companies into a single structure is to take advantage of synergies to cut costs and boost revenues.⁶⁸

According to the company's assessment, goodwill is attributable to future product and market opportunities gained from the acquired pan-European platform. In addition, the company expects cost savings and synergies, mainly in sales and product development. For further information concerning Meda's acquisitions in 2005, see appendix 7.4.

4.1.3.2 Interview with Meda

Unfortunately, the authors have not been able to get an interview with Meda since the company did not want to share company-specific information in an interview.

4.2 Interviews with analysts and auditors

The authors have made interviews with three analysts, experts covering one each of the three companies. Four auditors from the largest auditing firms have also been interviewed. The results from the interviews are presented further on but first the authors give a short introduction to the respondents' backgrounds.

Mats Larsson, analyst at Swedbank in Stockholm, has been working as a business analyst for 20 years. He has been at Swedbank since 1997 and before that he worked at Götabanken and Skandiabanken. Larsson analyzes a portfolio of small companies which includes Hexagon.

Richard Nilsson, analyst at SEB in Stockholm, has worked as an analyst concentrating on companies with forest-related production. Nilsson has been working at SEB since 1994 and as an analyst since the year 2000.

Sten Westerberg, analyst at Öhman Fonder in Stockholm, has worked at Öhman Fonder since 2001 and is today their expert analyst on health care companies. Westerberg's career within the analyst industry started in 1996 and before that he was the editor for the magazine *Veckans Affärer*.

Mikael Ekberg, senior manager and auditor at KPMG in Gothenburg, has worked as a chartered accountant for 16 years at KPMG. Before that he was group controller at ESAB. Ekberg works mainly with auditing and audit counselling.

Jan Hanner, auditor and accounting specialist at PWC in Öhrlings Gothenburg, has been working at PWC Öhrlings for 25 years. Hanner has to a large extent been involved in IFRS questions and deals with complex matters within this area.

Harald Jagner, senior manager and auditor at Deloitte in Gothenburg, has worked at Deloitte for twelve years. Jagner's main tasks include contact with both small and large companies, most of them listed. Jagner also works with matters concerning companies owned by the Swedish government.

Lars Nyqvist, senior manager at Ernst & Young in Malmoe, has worked more than ten years as auditor. The last seven years Nyqvist has been working with valuation and due diligence

⁶⁸ <http://www.meda.com>

matters within the firm. Before that he was business executive at a company quoted on the Stockholm stock exchange.

Below, the authors refer to the respondents by using only their surnames.

4.2.1 IFRS 3 compared to the earlier standard

The new regulation has meant large changes compared to the prior regulation. Larger changes than many have understood have taken place and that accounts for both companies and analysts, according to Ekberg. Ekberg and Hanner are generally positive to the new regulation. Ekberg says that “a grey zone has arisen with higher demands for accounting information and specification but this zone is covered by the IFRS.” Hanner also refers to a grey zone and says that despite the fact that the “new regulation is very pedagogical, the challenge lies in the grey zone in the new more subjective accounting.” Ekberg thinks that the first two years under the new regulation leaves a lot more to wish for in the financial reports but adds that it takes a while to introduce new standards. Ekberg means that first the accounting practitioners get involved and learn how the system functions and thereafter the operative executives need to learn the procedures.

Hanner agrees on this fact and means that an uncertainty exists right after the introduction of the new standards. Hanner continues: “different companies are differently disposed to accepting details in the regulation. Presumably, larger, more public, companies have more people involved in the process and thus follow the disclosure requirements and apply the details better than do other smaller companies.”

Even though Hanner is generally positive to the new fair value accounting, he is critical regarding to what extent companies explain and describe actions and motives behind the figures presented in the economic reports. The demands for information are high and Hanner does not think that that the companies live up to these demands. The introduction of IFRS requires a learning process for European companies and most of the companies try to do a good work with this, according to Ekberg. He adds that more time is spent on allocation and valuation matters now since the question has got more focus.

Jagner thinks that the difference between IFRS 3 and earlier regulation is related to the IFRS’ higher requests and demand for information. “The regulation framework is not complex but the application is.” This opinion is shared by Hanner who says that “theoretically the new regulation is right but it is not trivial to apply.” Jagner continues with the fact that “it is hard to have an opinion on a specific recommendation. You have to see it as a whole and the theory advocates valuation at fair value.” Hanner agrees and says that “the accounting at fair values should be seen as a whole phenomenon and is not specific for the IFRS 3 standard.” None-the-less, Hanner thinks that the most significant changes have occurred within that area.

Larsson thinks that many companies were careful in the beginning of the IFRS introduction: “one group worked with acquisitions and cash flow-models while some were stuck in the old goodwill amortization way of thinking but the companies accept the new rules and they now apply the rules.” The transition has not affected analysts to a large extent since they use cash-flow models, Larsson continues. Though, the possibilities to value relatively have increased considerably since all companies now use the same methods.

Jagner says that PPA, Purchase price allocation, is used to identify both tangible and intangible assets. Three years ago PPA was hardly ever used in acquisitions; today consultants often help companies in these matters. The deciding factor for this change is, according to

Jagner, the introduction of IFRS. Hanner also says that many, especially smaller, companies use external consultancy help.

Several respondents are of the opinion that, to compare the prior regulation with the newly introduced one you have to have in mind who the user of accounting information is. From the perspective of analysts and investors the regulation is quite unchanged compared to earlier existing frameworks. “Analysts are more interested in cash flow.” That opinion is also supported by all four interviewed analysts.

Nyqvist's opinion is that after the introduction of the IFRS 3 regulation, the analyzing of annual reports and business information has become more difficult. Nyqvist means that the many different kinds of assumptions that are possible to make within the frames of the new regulation makes the comparison of companies more difficult. The other three auditors agree on the opposite opinion that the introduction of IFRS 3 actually has improved the comparability between different companies. Despite this fact, Nyqvist thinks that after the IFRS introduction, the accounting information has become more clear since “it forces the acquirer to look into what it really is that they are buying and what it is that will generate cash flow in the future.”.

According to Jagner, an advantage of IFRS framework is the greater demand for information; however, this request is filled with subjective judgements from companies, which can be considered a disadvantage. Nyqvist and Jagner agree on the fact that when the uncertainty of the new regulations has decreased, it will work as a better basis for decision-making in the event of business combinations. With this better basis for decision making, it is easier for the companies' executives to reveal the information to the board of executives that in its turn can make judgments based on more reasonable information, Nyqvist says.

Jagner has a theory that concerns the price of an acquisition: “The more openly and structurally a company can specify its assets and show what it specifically owns, the lower risk the buyer sees and therefore he demands a lower risk premium. Thus, the prize becomes higher.” Also Larsson thinks that IFRS 3 has had an increasing effect on the purchase prizes.

4.2.2 True and Fair view

The question whether IFRS shows a more fair view of a company's state depends on who the user is. With IFRS, companies show a more fair economic view than earlier seen from an accountant perspective, according to Jagner. The perspective of analysts and investors is quite unchanged compared to earlier existing frameworks. Analysts are more interested in cash flow, Jagner continues. Hanner says that analysts have methods to exclude the goodwill effect on cash flows so to them no certain change has occurred with the introduction.

According to Ekberg, it is difficult to give an answer to whether the fair values of a company are shown in a better way now. Ekberg adds that theoretically this is right but further analysis is needed to scientifically investigate the effects.

Larsson says that companies are not easier to analyze now than before. Larsson adds that you must still handle the same questions but at the same time he agrees on the fact that values are made more visible. Further on he makes clear that “some things are strange in IFRS 3.” For example, as Hexagon agrees, the inventory should be valued at actual market price. That means that you have to write it down immediately or liquidate the inventory without margin. According to Larsson “this does not facilitate in any way”. Concerning this matter, Hanner is

of a totally different opinion and means that by an inventory's actual value IFRS refers to the price that some independent player would pay for it and not the price for the final customer.

Nyqvist claims that IFRS reveals a more fair picture of the financial statements in a company but at the same time he questions the expression "fair" since many subjective assumptions may be used in the calculations. The preceding regulation, RR 1:00, was put more in black and white according to Nyqvist. "A user of the financial information knew that the goodwill item consisted of, among other things, intangible assets and there was no need to specify these." Nyqvist adds that a user needs great knowledge to be able to judge whether the information is fair or not.

Hanner says that "judgements give more fair values" after the IFRS 3 introduction and he is very determined on this fact since "a company now should specify what it has purchased, in the form of assets and liabilities, not what it has paid which was the case before." Hanner finds IFRS 3 more intelligent than prior regulation and says that it is reasonable and logical to identify and establish fair value to as many assets as possible. Instead of using a fixed amortization period for the whole goodwill part, this is now divided into several different identified assets with varying usage periods. This, according to Hanner gives a "considerably better match of incomes and expenses to the right time period." Hanner says that the case might even be that companies amortize more after the introduction of IFRS 3 than before, despite the fact that the goodwill item is not amortized continuously anymore.

The share of the goodwill item relative the total acquisition cost has not increased compared to earlier, instead other items in the balance sheet are used when assigning the assets. This agrees with IFRS' demand for an increased need for specification and information. A phenomenon that this might have caused is the difference in valuation of companies. A stable and risk-free company that specifies all tangible and intangible assets correctly is valued higher than a company that has problems assigning assets to different items, according to Jagner. "It is a matter of making your assets visible for external parties, such as investors", Jagner continues. Larsson has not seen any tendency of change in goodwill share. However, he has noticed that in the end, companies have tried to allocate the acquisition cost to a much larger extent.

On the question concerning what amount of time companies use to make "fair" valuations and assignments of tangible and intangible assets in the event of a business combination, Nyqvist assumes that it is significant. Ekberg is of the opinion that profound, time-demanding, work is needed at acquisitions. Nyqvist adds that since the judgements and calculations made by the acquirer must be revised by the companies' auditors, it is impossible to use simple estimations of the different parts.

4.2.3 Allocation of acquisition cost

On the question whether incentives exist, for assigning a large share of the acquisition cost to goodwill, Nyqvist means that it is difficult to draw conclusions based on such a limited selection of companies. His hypothesis though, is that prices are generally high in the pharmaceutical industry and the sellers of such companies notice the valuation level on similar entities quoted on the stock exchange in order to get paid properly when selling.

Hanner finds it reasonable that companies from different industries assign different percentages of the acquisition cost as goodwill. He means that especially knowledge-based industries have a lot of goodwill since the personnel may not be accounted for. Hanner continues and says that in such companies it is difficult to know how to assign the acquisition

cost. As an illustrative example Hanner mentions a media company with the personnel's knowledge and ability as the most important asset. In that case, it is very difficult to decide whether the personnel asset should be assigned as customer relations, which it probably should since many customers follow specific employees when they switch jobs.

Concerning the hypothesis that some companies might use the goodwill item to affect its balance sheet in a wanted direction. Nyqvist, among others, means that this kind of solution is rather difficult and refers to the fact that impairments must be done every year if the expected future profits cannot be maintained. Thus, the effects of such a construction would be only short-term.

According to Jagner, fluctuations in goodwill can be explained by the size of the acquisition relative to the company that executes the acquisition. Jagner is fairly sure that companies use external help in the cases when the acquisition cost exceeds a certain limit and if not they realize the valuation themselves. Another explanation to the fluctuations is that different industries consist of companies with various balance sheets. Large differences exist between manufacturing companies and companies that supply only services. It is also a matter of experience. Companies that have effected many acquisitions and have a routine of doing so work differently than others that do not have this experience, according to Jagner. This opinion is shared by Hanner who says that "there is a huge difference between companies effecting an acquisition every five years and companies that effect acquisitions continuously. The companies with lacking experience often need to consult experts."

Jagner says that there are some practical problems when valuing assets in an acquisition. It can be hard to assign the correct amount to a certain item in the balance sheet. Questions regarding what values to assign to an acquired brand or customer relations and what amortization period to use for these assets is difficult to answer, according to Jagner.

Regarding the reliability of allocations, Ekberg has given his opinion. He says that "all companies want to follow the regulation or else they get negative publicity in the long run and that most companies follow the regulation to the best of their ability." Hanner agrees on this fact and adds that companies actually probably want to assign as little to goodwill as possible to avoid negative "surprises" with large impairments in the future. Ekberg means that since judgements are involved, the information is difficult to verify and therefore the risk increases. Furthermore, he says that since impairment tests must be effected, the probability of getting away with certain constructions is low: "the auditors work as a safety net. If the auditor feels that the impairment test effected by the company in some way is incorrect he or she gives his or her opinion."

4.2.4 Impairment tests

Larsson means that the impairments may be postponed by referring to future profits. Larsson thinks that a company quite easily may postpone the write-down with the motive that a recession state exists and that the profits are calculated into the future. His standpoint is that "auditors will not threat with knife for this matter." According to Jagner, this is not possible: "You must show in which way you will get these future profits and it is not enough by motivating." The company must convince the auditor of the fact that the intangible asset really exists, which also Nyqvist and Hanner agree upon.

Jagner means that the auditor interacts with the company throughout the year, which gives the accounting information reliability. "If the company in question diverges from its plan and does not show these future profits as they planned they will have to write down." On the

other, hand Jagner says, “of course, if you want to boost the result a certain year it is possible. But sooner or later reality catches up with you. If you, for example decide to account with an amortization period of ten years and you lose the customer after two, you will have to write down and take it as a cost directly.”

Westerberg is of the opinion that companies want to assign as much as possible to goodwill since it “looks good” in the economic statements. The majority of the auditors, though, agree on the fact that yearly impairment tests impede the companies in assigning *false* goodwill values. Larsson contradicts his above mentioned statement regarding impairment postponement when he says that he thinks “impairment tests might be rough at the next recession.” This might be a sign of the unclear character and application that IFRS 3 has brought with it.

Hanner adds that impairments can be avoided even if former expected profits in the acquired company fail to come. If the acquiring company generates profits, the company may refer to these when motivating that these future profits actually have existed in the acquired company. Hanner continues and says, in accordance with Gervide at Hexagon, that it is possible to adjust the parameters when discounting the values of future cash flows to today. “By adjusting, for example, inflation rates or discount interest rates there is certain space to avoid impairments.” However, Hanner continues, “the auditors’ task is to control and effect ‘sanity checks’ by comparing companies within the industry.” “However, under the condition that the economic reports contain sensitivity analysis including several possible alternatives regarding the parameters, the auditors will probably let it pass”, Hanner concludes.

Larsson speculates on the fact that the market “at least not has become more long-term.” CEO:s spend less time in a position now than before and Larsson thinks that personal incentives might exist to adjust economic statements in a certain direction. He continues with “you can build up profits but you do not have to deal with the waste yourself.” Larsson adds that “a large goodwill item is at least not a burden.” In contrast to this, Westerberg says that” of course it is not an advantage from the investor point of view to carry a large goodwill item or intangible asset, respectively.

4.2.5 Company-specific questions

Concerning the three analyzed companies, Stora Enso, Meda and Hexagon, the majority of the respondents agree on the fact that a large difference in goodwill size obviously is due to the different characters of the companies and the industries in which they act. The others question why belonging to a specific industry should affect the goodwill part of the total cost in an acquisition. According to Jagner, the health-care industry does not have more assets that are difficult to specify, than have other industries. Nor does Westerberg see any explanation to large differences in goodwill between different industries. He, as an analyst of Meda and the health-care industry, was surprised by the large part of the total cost that Meda actually assigned to goodwill. Even though Ekberg agrees with Jagner and Westerberg in this matter, he is, on the other hand, also of the opinion that it in some cases it may be hard to identify the assets.

In the Stora Enso case, Nyqvist supposes that a large part of the acquisition cost may be assigned to over-values in tangible assets since such industries generally have large tangible assets and corresponding overvalues. “Another reason for a small goodwill amount might be that the price level in that industry is not that high.” Especially since the largest acquisition made by Stora Enso that year was a German company, Nyqvist means that, there might exist

over-values. This comes down to the fact that German regulation, in accordance with Swedish regulation, form part of the continental tradition, which advocates a conservative valuation of assets.

Larsson agrees with Nyqvist on the fact that there is a considerable difference in type of company and industry. Forest related companies are cheap because of low profitability and profits; he says and adds that “when the prices are low, the goodwill is as a consequence also low.”

Another explanation for a small goodwill part of the total acquisition cost is that there is an uncertainty about the future of the paper mill industry. As a logical consequence the prices on equity are low. Larsson, despite the fact that he generally thinks that the industry-belonging directly affects the goodwill share a company allocates, is of the opinion that even a forest-related company might obtain great effects from synergism. If two unique companies in a market merge, they may dictate the terms and great effects of synergism and consequently a large goodwill item would be the result.

Meda, which assigned 93 percent of the acquisition cost, is a pure distributing company, thus the expected future profits from an acquisition might be extremely large. The acquirer buys the distribution channel and sees a large potential in future turnover and profit growth. Also, effects of synergism are indeed significant in the distribution of the pharmaceuticals industry, according to Nyqvist. Larsson is of the opinion that synergies in the distribution channel make up the largest part of the goodwill value in the Meda case: “they pay considerable amounts of money since they know that synergies will arise and the more synergies, the higher amount of goodwill.” Larsson thinks that it should be possible to allocate the product rights as specific assets but says that because of the intangible and uncertain character of distribution channels, these cannot be allocated to a specific item.

Larsson’s opinion is in sharp contrast with what Jagner thinks, who says that profits from obtaining access to a distribution channel actually can be specified and therefore also assigned as an intangible asset. As mentioned above Jagner does not see any explanation to why health-care companies should tend to have more goodwill assigned compared to other industries.

Ekberg is critical to some companies’ economic reporting and specifications of the goodwill value: “you have to justify and explain in detail why you have not been able to allocate other intangible assets.” However, he adds, that differences in goodwill as a percentage of total acquisition cost does not necessarily mean that something is strange. “Theoretically, everything can be synergies and goodwill. Spontaneously, it might sound a lot but without analysing the PPA it is impossible to give a straight answer”, according to Ekberg. Hanner’s opinion is that 93 percent might seem high but since some acquisitions give access to new markets and distribution channels for existing products, it does not have to be wrong.

Regarding Hexagon’s allocation of the acquisition cost, Larsson says that the same principle as for Meda works for Hexagon, that is that considerable synergies arise in software application. And, as mentioned above, the more synergies, the more goodwill.

4.2.6 How does the IFRS 3 introduction affect analysts’ practical work?

Larsson does not put much effort into IFRS 3. Larsson, like the analysts, investigates the way companies choose to do their accounting. He wants to get a feeling of the accounting mode

the companies use: “Do they try to allocate or do they assign all on goodwill? This, in its turn, shows their style. Are they conservative? It can be instructive to know their style. Do they try to take shortcuts or not?”

Westerberg is of the opinion that the introduction of IFRS 3 has made it easier to compare companies with different home stock exchanges since methods in accounting earlier differed from each other. “It has simply improved the comparability” Westerberg says. Apart from that he has no specific opinions on whether IFRS 3 better or worse shows a company’s true and fair value. Westerberg finds it hard to see the positive effects related to the introduction of IFRS 3 but he thinks it is good that the purchase price is allocated on a larger amount of tangible and foremost intangible assets, that “especially in an industry such as the health-care industry might be difficult to effect.” Regarding the question whether IFRS 3 makes the fair view of a company’s economic statement more visible, Westerberg expresses that it does not affect his view of economic statements considerably and refers to that the most important thing is to also continuously separate acquired and organic growth from each other.

Westerberg and his analysts’ colleagues mainly analyze companies from a cash flow perspective. “How companies decide to handle goodwill affects earnings per share, EPS, but not the cash flow”, Westerberg says. This means that it is not very important or interesting how companies prefer to assign the purchase price to different items in the balance sheet, since there is no effect on the cash flow. Hence, the same way of working applies for all the other interviewed analysts, independent of company. However, Westerberg argues, that tax and possible tax deductions related to write-downs of goodwill affect the cash flow.

Larsson means that Hexagon have tried to allocate acquisition cost between tangible and intangible assets and sees this as positive. He continues with the idea that it is good to allocate and amortize the parts that are exhausted and consumed.

As to whether it is possible for companies to adjust the accounting in a certain way Larsson says that the possibility exists. He also says that everybody does not use the possibility to create EPS growth by acquisitions. “Before, companies had to amortize the goodwill to get an EPS effect but then possible acquisitions were too expensive. Now the possibilities are greater” Larsson adds.

5. Analysis

In this chapter the authors have analyzed the results from the empirical data put in relation to the reference frame.

5.1 Analyzed companies

5.1.1 The acquisitions

Stora Enso claim that with the acquisition synergies in the form of better efficiency in logistical flows, merging of overlapping operations and better purchase conditions from external suppliers are achieved. In Stora Enso units increased sales volumes are expected. These arguments are well connected to *economies of scale*, mentioned in the reference frame. Economies of scale can, for example, decrease the marginal cost of a specific product when it is produced on a larger scale. Economies of scale also emerge when product technology or large purchases cause discount prices, which is exactly what Stora Enso hope to achieve with their acquisition.

Hexagon state that their acquisition will generate synergies through gaining access to the purchased company's technology. A technology transfer between market segments will enhance the Hexagon's customer offering. The acquisition also creates operational synergies through larger platforms for research and development, component procurement, aftermarket services and software development. The operational synergies confer on Hexagon the possibility of attaining higher margins and competitive advantages. A motive for an acquisition is that the company acquired has *complementing resources* which the purchasing company can share. A resource can be all sorts of assets, competence, information, knowledge and so forth. Complementing resources exist when two companies can share each other's resources in order to enhance their common competitive advantage on the market, which in this case is quite evident. The complementing resource theory is in general achieved in most successful acquisitions; however, it is, according to the authors, in Hexagon's case the very most obvious reason for the acquisition. Since studies of mergers and acquisitions that have been made indicate that the shareholder value added is higher if the companies have complementing resources instead of resources in common, the authors claim that the acquisition made has a good theoretical base for achievement.

It is more difficult to specify which acquisition theory is applicable as a theoretical motive for the acquisition in Meda's case. Meda argue that the companies complement each other with respect to products and geographic regions, which can be considered a *complementing resource*. There are also product synergies achieved, because Meda's products now can be simultaneously sold on several markets. This is connected to the acquisition theory concerning *management* where access to marketing and distribution nets are seen as motives for acquisitions.

Meda has no production facilities, all manufacturing is subcontracted. The acquired company has production capacity and pharmaceutical development, which will enhance the value of the existing product portfolio. According to the company's assessment, goodwill is attributable to future product and market opportunities. In addition, the company expects cost savings and synergies, mainly in sales and product development. An acquisition theory, which is applicable in this case, is the *economies of scope* theory, this due to the fact that Meda apply their knowledge to a related business area.

5.1.2 Company specific interviews

Earlier standards

Compared to earlier regulations, IFRS emphasizes that an increased amount of accounting information should be produced in the event of an acquisition.

Gervide and Siitonen think that the increased disclosure requirements have been the largest challenge with the new regulation. However, this has not affected the operations in Hexagon in a significant way and no difficulties with understandability have occurred. Siitonen's opinion is that IASB have simplified the accounting procedure by clarifying certain items and the way these should be classified at an acquisition.

According to the standard, disclosure requirements of intangible assets are considerably larger with the introduction of IFRS 3 than before. Except for their customer base, Stora Enso do, however, not possess considerable intangible assets so these increased disclosure requirements do not affect Stora Enso to a large extent. Hexagon, on the other hand, have acquired intangible intensive organisations so to them the changes should be more significant.

True and fair view

Regarding the question of how IFRS shows a company's true and fair view, Siitonen's opinion is that it is very difficult to meet the standard's requirements. Gervide says that the fact that you must specify the separate parts makes the values a bit misleading since you should buy a company as a whole and not the parts of it. The authors have come to the conclusion that the fair values actually are shown in a worse way than before despite IFRS' opposite intention. But, on the other hand, other respondents, such as auditors, claim that the new regulation shows the fair values better.

However, the comparability between companies, which is emphasized by the IFRS framework, is significantly better than with prior regulations. If companies really spend time on creating accounting according to the detailed disclosure requirements, a very transparent comparison between the state of companies will be possible, according to Siitonen.

Valuation methods in an acquisition

Subjective judgements have, with the introduction of IFRS, become more important when valuing acquired assets. Stora Enso use external valuation experts to assign the proper value of purchased assets in all acquisitions after the introduction of IFRS 3. Stora Enso mainly estimate the values of key customers and calculate future value based on cash flows. Stora Enso use different depreciation periods depending on the estimated time until the customer becomes profitable. Gervide mentions two subjects that affect the Hexagon valuation process significantly; inventories and, even more, the customer lists. According to Gervide the customer lists are difficult to value due to the uncertainty regarding their life expectancy. A common denominator in the valuation process apparently is the difficult handling of customer list items. Values are assigned differently depending on the expected utilization period of an asset.

In contrast to Stora Enso, Hexagon do not use external valuation experts. Instead, they effect these subjective valuation matters on their own. Hexagon estimate the value of the acquired entities' assets to the cash flow generated in the acquired company. Accordingly, there are different ways to value assets in acquisitions.

As mentioned above, Gervide means that it is incredibly difficult to assign valuations to for example the customer lists since “You estimate for how long they will stay with you or when they will disappear as customers.”

Impairment test

With the introduction of IFRS 3, impairment tests of goodwill have become more demanding. Despite this fact, the effect on Stora Enso has not been considerable since the company already before the introduction of IFRS prepared for “worst case scenarios” at the time of acquisitions to discover potential risks of impairment in the future. To Hexagon the more frequent and demanding impairment tests have not had large effects. Tests were conducted even before, although they were conducted more irregularly before the introduction of IFRS.

Result management

The fact that goodwill does not have to be amortized anymore affects profits.

Siitonen means that the new regulation gives fewer opportunities for result management since the demands for proving your goodwill are higher. The manipulation possibilities of accounting are limited to the determination of the depreciation period, according to Siitonen. On the other hand, Gervide thinks that manipulation is possible by adjusting the discount parameters and by the way you account the customer lists. This is an obvious example that practitioners have different opinions concerning accounting as a result management tool. A conclusion of this is that the amount assigned to goodwill in an acquisition fluctuates due to practitioners’ different opinions concerning result management.

Thoughts about differences in goodwill

IASB define goodwill as “future economic benefits arising from assets that are not capable of being individually identified and separately recognised”. Companies possess varying amounts of such indefinable assets depending on how large synergy effects they estimate to achieve from their acquisitions in the future.

Siitonen’s theory is that differences exist between companies from different industries, regarding the difficulty to allocate the acquisition cost between purchased assets. For example, the pharmaceutical industry is based on innovations that should be accounted for as intangible assets. Consequently, it should be easier to allocate the goodwill between certain items in such companies. This statement is in contrast to reality since Meda actually assigned only seven percent of the total net acquisition cost to non-goodwill assets. This is an example of diverging opinions on how to handle matters regarding allocation of assets at acquisitions.

Based on the empirical results, the authors argue that the fact that Meda assigned such a large amount to goodwill does not mean that the company has done anything wrong. Instead, one must consider the future profits that are achievable due to synergy effects. In Meda’s case, a combination of different synergy effects such as economies of scope, shared management and complementing resources in operations may have contributed to the larger goodwill share. When looking at Stora Enso’s acquisitions, their expected synergy effects are limited to larger scale production by sharing facilities. The authors have thus come to the conclusion that the amount of goodwill to a large extent depends on how large synergy effects the acquirer expects to achieve in the future.

Two respondents claim that the increased disclosure requirements have led to higher prices in acquisitions since the companies’ values in the balance sheets now are more visible. The

authors believe that it supposedly is more difficult to find assets on which to allocate the higher acquisition cost. These higher prices in some cases might increase the goodwill share since the acquirer still buys the same set of assets and thus must assign a price premium as goodwill. The authors claim that this might be an explanation to the large goodwill share assigned by Meda.

5.2 Interviews with analysts and auditors

5.2.1 IFRS 3 compared to earlier standards

With the introduction of IFRS, the demands to produce and provide accounting information have become higher.

When comparing the new standards to the prior standards, one must consider who the user of accounting information is. Several auditors agree on the fact that the producing of accounting information is more difficult while, at the same time, the analyzing of accounting information is easier. Three responding auditors agree that the comparability between companies has become a considerably easier task. Nyqvist, however, claims that analyzing and comparison between companies have become more difficult due to the existence of more subjective judgments in the accounting. This implies that the effect from the introduction of the new regulation regarding the comparability is a debatable subject.

Uncertainty exists regarding the implementation of the new standards. The auditors agree on the fact that the framework is theoretically well formed but that the application is complex. This is also in accordance with the respondents from Hexagon and Stora Enso who think that the new regulation is difficult to apply in practice. As a consequence of this, companies consult expert knowledge to a larger extent than before.

One positive effect of the introduction of IFRS is the greater demand for information. However, this information is to a large extent based on subjective judgments which can be seen as a possible disadvantage regarding reliability.

5.2.2 True and Fair view

IFRS emphasizes that the reporting of accounting information should reflect the true and fair view of a company.

All four auditors interviewed are of the opinion that IFRS shows a more true and fair view of a company's actual state. The question whether IFRS shows a more fair view of a company's state also depends on, as mentioned before, who the user is. With IFRS, companies show a more fair economic view than earlier, seen from a practitioner perspective. From the perspective of analysts and investors the actual state of a company is better shown in comparison to earlier existing frameworks. However, the authors have come to the conclusion that analysts are far more interested in cash flows and therefore effects on analysts from the transition have been quite limited. The acquisition cost is now allocated to a larger number of assets than before when goodwill also consisted of some intangible assets. As a consequence, several amortization periods are used. The authors have come to the conclusion that this gives a better match of incomes and expenses and hence a more true and fair view of the accounting records.

Nyqvist claims that IFRS reveals a more "fair" picture of the financial statements in a company but at the same time he questions the expression "fair" since many subjective assumptions may be used in the calculations. The preceding regulation, RR 1:00, was put

more in black and white according to Nyqvist. Nyqvist's opinion is that after the introduction of the IFRS, the analyzing of annual reports and business information has become more difficult. Nyqvist means that the many different kinds of assumptions that are possible to make within the frames of the new regulation makes the comparison of companies more difficult. Larsson says that companies are not easier to analyze now than before.

Analysts' opinions, on whether the true and fair view of a company's state is better visualized now than with prior regulation, diverge. Westerberg is of the opinion that the comparability has improved substantially and is, in accordance with Larsson, in general positive to the IFRS. Since the authors have understood that the analyst respondents do not put that much effort into accounting information in general and certain standards in specific, their answers should probably be seen with more critical eyes in comparison to the more well-informed auditors.

5.2.3 Allocation of acquisition cost

The *disclosure requirements* of intangible assets are considerably larger with the introduction of IFRS 3 than before. According to the respondents, there are practical problems when valuing assets in an acquisition. To assign the correct value and determine the amortization period of a certain item in the balance sheet are difficult matters.

Fluctuations in goodwill might be explained by the fact that different industries consist of companies with various balance sheets. Great differences exist between manufacturing companies and companies that supply only services. It is also a matter of experience. Companies that have effected many acquisitions work differently than others that do not have such experience. Fluctuations in goodwill can also be explained by the size of the acquisition relative to the company that executes the acquisition.

The more openly and structurally a company can specify its assets and show what it specifically owns, the lower risk the buyer sees and therefore he demands a lower risk premium. The authors have experienced that this greater specification of values in the balance sheet has led to an increased price level in acquisitions.

5.2.4 Impairment test

Goodwill is no longer an item for amortisation as was the procedure before. The value of goodwill should rather be *tested for impairment* on, at least, a yearly basis according to the regulation in IAS 36 Impairment test. If an indication arises, of falling value of goodwill between two balance dates, an impairment test should be pursued.

Concerning the hypothesis that some companies might use the goodwill item to affect their balance sheets in a wanted direction, all four auditors mean that this kind of solution is rather difficult since impairment tests must be conducted every year if the expected future profits cannot be maintained. However, three other respondents claim that it is possible to for example adjust discount parameters to avoid impairment. The authors believe that this might be an indication of auditors' generally conservative and law-bound approach compared to company representatives and analyst. In other words, the respondents' opinions concerning impairment tests are diverge.

5.2.5 Company-specific questions

The three investigated companies, Stora Enso, Hexagon and Meda, have assigned different shares of their acquisition cost to goodwill.

The majority of the respondents agree on the fact that a large difference in goodwill size obviously is due to the different characters of the companies and the industries in which they act. However, two respondents see no explanation for large differences in goodwill between different industries. They claim that the health-care industry does not have more assets that are difficult to specify than other industries.

Some respondents argue that a large part of the Stora Enso acquisition cost may be assigned to over-values in tangible assets since such industries generally have large tangible assets and corresponding overvalues. Two respondents claim that forest related companies are cheap because of low profitability and existing uncertainty about future profits. When the prices are low, the goodwill is as a consequence also low. Accordingly, these arguments partly explain why Stora Enso assigned a smaller part of the net acquisition cost to goodwill than did the others.

Meda, a pure distributing company, assigned 93 percent of the acquisition cost and expect large future profits. Despite the large amount, several respondents mean that this figure must not be incorrect. Some respondents argue that Meda buys the distribution channel which means large potential in future turnover and profit growth. Effects of synergism are indeed significant in the distribution of pharmaceuticals industry but access to a distribution channel cannot be assigned as an asset, according to Larsson and Nyqvist. On the other hand, Jagner is of the opinion that profits from obtaining access to a distribution channel actually can be specified and therefore also assigned as an intangible asset. A company must justify and explain in detail why an allocation on other intangible assets has not been possible. Ekberg and Hanner are, however, critical of companies' economic reporting which they, in many cases, do not think reaches certain standards.

Regarding Hexagon's allocation of the acquisition cost, respondents mean that considerable synergies arise in software application. Hexagon have also acquired the right to use certain brands in the future. These brands should be accounted for as intangible assets and should therefore not be included in the goodwill item as before. Hence, the authors have come to the conclusion that the goodwill share in Hexagon's acquisition is considerably smaller than it would have been if using the prior regulation.

The largest difference in goodwill is between Meda and Stora Enso which assigned 93 and 35 percent respectively to goodwill. There are, as mentioned above, huge differences in type of company and industry of Meda and Stora Enso. Thus, future profits are developing differently between the two companies. Meda is a player in the very profitable pharma-distribution industry whereas Stora Enso struggle in the more saturated paper and forest related industry. The authors argue that this is the most important reason why the two companies assigned such different shares of the total acquisition cost as goodwill. However, some difficulties seem to exist, regarding the way certain assets should be accounted for. For example, the fact that Meda gain access to new, already existing distribution channels by acquiring other companies, means enormous opportunities of future profits. However, the respondents have diverging opinions whether this asset should be accounted as an intangible asset or as part of goodwill. The authors have come to the conclusion that despite the fact that the new regulation is quite easy to understand, some areas still need to be even more clarified.

5.2.6 How does the IFRS 3 introduction affect analysts' practical work?

The general opinion of analysts regarding the introduction of IFRS 3 is that it has not changed their way of working considerably. The way a company handles the acquired assets and

excessive goodwill affects its EPS, earnings per share, but not its cash flow, except regarding tax deductions. Analysts use future cash flow models to value companies and in these models, allocations of acquisition costs are rather insignificant. The authors have realized that independent of accounting regulation, analysts have models to exclude profit and loss statement-affecting items from the calculations.

The authors have come to the conclusion that analysts possess varying degrees of knowledge concerning accounting matters. One of the respondents had great expert knowledge on the subject whereas another one hardly knew about the existence of IFRS 3. The authors find this extremely surprising especially since one of the respondents argued that cash flows actually are affected by allocation decisions. The authors have with the work with this report gained a greater understanding of why gigantic accounting scandals can occur without shareholders knowledge. If the authors had a critical standpoint on analysts before, this has been considerably strengthened during the work with this report. It is, however, important to mention that many analysts probably possess enough knowledge to make intelligent decisions.

6. Conclusion

The results obtained by the authors from the work with this report are presented in this conclusion chapter.

The purpose with this report has been to investigate the two following questions:

How do companies reason when applying the part of IFRS 3 that concerns allocation of the acquisition cost between different assets in the event of a business combination?

How, and to what extent, do companies' allocations of acquisition cost affect users', in form of analysts, opinions of the accounting information?

Several reasons exist to why companies allocate acquisition costs differently in the event of a business combination. The authors have crystallized some of these explanations in the work with this report.

The authors have come to the conclusion that the amount of goodwill assigned in an acquisition, to a large extent depends on how large synergy effects the acquirer expects to achieve in the future. Effects of synergism are significant in the distribution of the pharmaceuticals industry. However, opinions diverge as to whether it is possible to assign an acquired distribution channel as a specific asset.

Depending on in which industry a company operates the conditions for future profit growth differ. Meda is a player in the profitable pharma-distribution industry whereas Stora Enso operate in the more saturated paper and forest related industry. The authors argue that this is the most important reason why the two companies assigned so different shares of the total acquisition cost as goodwill.

Higher disclosure requirements in IFRS 3 compared to earlier standards has led to higher prices in some acquisitions because of the visualization of assets in the balance sheet. This might increase the goodwill share since the acquirer still buys the same set of assets and thus must assign a price premium as goodwill. The authors claim that this might be an explanation to the large goodwill share assigned by Meda.

Another reason for differences in goodwill might be management. Practitioners have different opinions concerning accounting as a result management tool. A consequence of this might be that the amount assigned to goodwill in an acquisition fluctuates due to practitioners' different opinions concerning result management. However, auditors argue that the possibilities of result management are limited. The authors believe that this might be an indication of auditors' possible conservative and law-bound approach compared to company representatives and analysts.

Fluctuations in goodwill can also be explained by the size of the acquisition relative to the company that executes the acquisition. Companies with management that have effected many acquisitions work differently than others that do not have such experience. The size of the synergy effects, and hence the goodwill, depend on to what extent companies take advantage of each other's knowledge and operations.

The authors' conclusions concerning true and fair view with IFRS are that opinions diverge. From a practitioners' perspective the fair values are actually shown in a worse way than before despite the IFRS' opposite intention. But, on the other hand, other respondents, such as auditors, claim that the new regulation shows the fair values better. Whether a more true and fair view is reflected thus depends on who the shareholder is.

Regarding the second question formulation the authors have come to the conclusion that analysts are far more interested in cash flows and therefore effects on analysts from the transition have been quite limited.

7. Appendices

7.1 Exemplification of allocation of acquisition cost

	Minus		Finance	
	Fair Value CU'000	Book Value prior to acquisition CU'000	Fair Value CU'000	Book Value prior to acquisition CU'000
Net assets acquired				
Current assets:				
Cash	300	300	150	150
Receivables	492	492	50	50
Non-current assets:				
Investments	–	–	300	300
Intangible Assets	50	–	–	–
Property, plant and equipment	404	367	100	95
Current Liabilities				
Payables	(96)	(96)	(50)	(50)
Provisions	(37)	(37)	(10)	(10)
Non-current liabilities:				
Contingent liability	(15)	–	(27)	–
Borrowings	(58)	(58)	–	–
Net assets acquired	1,040	968	513	535
Goodwill on acquisition ^(B)	82		–	
Discount on acquisition ^(A)	–		36	
	1,122		549	

7.2 Stora Enso acquisition 2005

Acquisitions in 2005

EUR million	Total Group Acquisitions			Schneidersöhne Group		
	Total Value	Allocated Fair Values	Acquired Book Value	Total Value	Allocated Fair Values	Acquired Book Value
Tangible fixed assets	187.9	41.7	146.2	145.0	35.8	109.2
Intangible fixed assets	86.4	84.4	2.0	85.1	83.1	2.0
Goodwill	114.0	114.0	-	114.0	114.0	-
Total Fixed Assets	388.3	240.1	148.2	344.1	232.9	111.2
Associated Companies	1.2	-	1.2	1.2	-	1.2
Operative receivables: Non-current	24.2	-	24.2	24.1	-	24.1
Current	230.8	-0.3	231.1	165.8	-	165.8
Inventories	94.9	7.7	87.2	78.5	7.2	71.3
Cash	10.3	-	10.3	0.9	-	0.9
Tax assets	5.6	1.7	3.9	5.5	1.7	3.8
Total Assets Acquired	755.3	249.2	506.1	620.1	241.8	378.3
Group shareholder equity acquired	328.9	203.3	125.6	202.7	199.7	3.0
Minority Interests	-93.3	0.9	-94.2	-	-	-
Net Equity Acquired	235.6	204.2	31.4	202.7	199.7	3.0
Operative Liabilities: Non-current	44.0	1.4	42.6	41.9	-	41.9
Current	135.7	-	135.7	74.7	-	74.7
Debt: Non-current	103.0	-	103.0	87.0	-	87.0
Current	171.6	-0.4	172.0	152.8	-0.3	153.1
Tax Liabilities	65.4	44.0	21.4	61.0	42.4	18.6
Total Equity & Liabilities Acquired	755.3	249.2	506.1	620.1	241.8	378.3

7.3 Hexagon acquisition 2005

GROUP

Intangible fixed assets

2005	Capitalised Expenditure on Research and Development	Patents and Trademarks	Goodwill	Other intangible fixed assets	Total
Acquisition value, opening balance	181	137	1,981	16	2,315
Translation differences	30	3	246	-	279
Investments	136	4	0	-	140
Investments via acquisitions of subsidiaries	545	3,322	4,516	242	8,625
Sales/disposals	-13	-1	-11	-	-25
Sales via divestments of subsidiaries	-19	-3	-68	-	-90
Reclassification	-	3	-2	-	1
Acquisition value, closing balance	860	3,465	6,662	258	11,245
Depreciation, opening balance	-40	-47	-240	-1	-328
Translation differences	-6	-4	-3	0	-13
Depreciation for the year	-85	-20	-	-3	-118
Sales/disposals	3	1	11	-	15
Sales via divestments of subsidiaries	8	2	11	-	21
Reclassification	-1	-	2	-	1
Depreciation, closing balance	-131	-68	-219	-4	-422
Write-downs, opening balance	-	-	-9	-	-9
Translation differences	-	-	-1	-	-1
Sales via divestments of subsidiaries	-	-	10	-	10
Write-downs for the year	-162	-	-	-	-162
Write-downs, closing balance	-162	-	-	-	-162
Residual value according to plan	567	3,397	6,443	254	10,661

The Acquisition of Leica Geosystems Holdings AG

Acquisition costs	
New issue 1	2,194
Cash 1	6,393
New issue 2	18
Cash 2	44
Costs	101
Total acquisition costs	8,750

Acquired net assets	Cash Flow	Liability Supple- mentary		Acquisition Balance Sheet
		Purchase Price	Acquisition Costs	
Intangible fixed assets	8,601	-	-101	8,500
Fixed assets	531	-	-	531
Financial fixed assets	406	-	-	406
Current receivables, inventories, etc.	1,954	-	-	1,954
Liquid assets	38	-	-	38
Provisions	-1,066	183	-	-883
Long-term liabilities	-435	-	-	-435
Current liabilities, etc.	-1,279	139	-	-1,140
Sub-total	8,750	322	-101	8,971
Less liquid assets in acquired group companies	-38	-	-	-38
Less contribution in kind, parent company	-2,212	-	-	-2,212
Less purchase price, entered as a liability	-	-322	-	-322
Plus acquisition costs	-	-	101	101
Cash flow from acquired group companies, net	6,500	0	0	6,500

7.4 Meda acquisition 2005

NOTE 18 SPECIFICATION OF COMPANY ACQUISITIONS

On 5 August 2005 the Group acquired 100% of the share capital in the Viatris group, a pharma company with operations in most West-European countries. The Viatris group has been consolidated as from this date.

The acquired operation contributed with net sales of SEK 1,432 million and an operating loss of SEK 95.3 million (including restructuring costs of SEK 176.3 million) to the Group for the August-December 2005 period. If the acquisition had occurred on 1 January 2005, the Group's net sales would have been SEK 5,056 million and operating profit for the period would have been SEK 573.7 million (including restructuring costs of SEK 176.3 million). This table presents data on acquired net assets and goodwill:

	SEK million
Purchase price	
- cash payment	5,459.6
- direct costs in conjunction with the acquisition	4.0
Total purchase price	5,463.6
Fair value of acquired net assets	-365.7
Goodwill	5,097.9

These assets and liabilities were included in the acquisition:

	Fair value	Acquired book value
Product rights		
- Product rights (included in the Product rights item)	1,319.6	721.0
- Licensing rights (included in the Product rights item)	580.4	-
- Customer contracts (included in the Product rights item)	15.9	-
- Other intangible assets	14.9	5.8
Goodwill	-	625.0
Property, plant, and equipment	744.0	744.0
Financial assets		
- Deferred tax assets	189.0	581.2
- Other financial assets	8.3	8.3
Other current assets	1,221.2	1,221.2
Non-current liabilities		
- Deferred tax liabilities ¹⁾	-687.9	-40.9
- Other non-current liabilities	-1,824.4	-1,824.4
Current liabilities	-1,215.3	-1,210.3
Acquired net assets	365.7	830.9
Goodwill	5,097.9	
Total purchase price	5,463.6	
Cash and cash equivalents in the Viatris group	-212.0	
Change in Group cash and cash equivalents in acquisitions	5,251.6	

¹⁾ Mainly refers to deferred tax on the difference between acquired book value and fair value of product rights. The deferred tax liability is gradually released when product rights are amortised.

7.5 Interview material for analysts

We have, with help of annual reports from 2005, analyzed IFRS 3 Business combinations. We are interested in the companies' understanding regarding this standard. We want to investigate the reasons why companies assigned a certain part of the total net acquisition cost to goodwill.

1. Please describe your own background and for how long you have been working within the current business segment.
1. Is your analytical work specialized in any industry? If yes, which?
2. What are your thoughts concerning IFRS 3 and those rules this regulation brought? In what way, compared to the earlier standard RR 1:00, does it show companies' real value? Should the rules be formed differently in order to show a true and fair view?
2. How does IFRS 3 affect your work in analyzing companies and their future? What has the transition to IFRS and the introduction of IFRS 3 meant for you?
3. Why do you think the amount assigned to goodwill in the companies presented below differs this radically?
 - Meda assigned 93 percent to goodwill in their acquisition
 - Hexagon assigned 52 percent to goodwill in their acquisition
 - Stora Enso assigned 35 percent to goodwill in their acquisition

Are these industry specific causes or is it possible that other reasons exist?

4. Can you see any changing tendency with quoted companies concerning the amount assigned to goodwill compared to before the introduction of IFRS 3? If yes, what are the causes for this change?

Is it possible that companies don't apply IFRS 3 correct and it by doing so accrue fluctuations in goodwill?

7.6 Interview material for audit firms

We have, with the help of annual reports from 2005, analyzed IFRS 3 Business combinations. We are interested in the companies' understanding regarding this standard. We want to investigate the reasons why companies assigned a certain part of the total net acquisition cost to goodwill.

1. Please describe your own background and for how long you have been working within the current business segment.
2. What are your thoughts concerning IFRS 3 and those rules this regulation brought? In what way, compared to the earlier standard RR 1:00, does it show companies' true and fair value? Should the rules be formed differently in order to show a better view?
3. How much effort do you think that practitioners put down in order to assign correct values to tangible and intangible assets and goodwill respectively in the event of an acquisition?
4. Can you see any changing tendency with quoted companies concerning the amount assigned to goodwill compared to before the introduction of IFRS 3? If yes, what are the causes for this change?
5. Why do you think the amount assigned to goodwill in the companies presented below differ that radically?
 - Meda assigned 93 percent to goodwill in their acquisition
 - Hexagon assigned 52 percent to goodwill in their acquisition
 - Stora Enso assigned 35 percent to goodwill in their acquisition

Are these industry specific causes or is it possible that other reasons exist?

7.7 Interview material for the analyzed companies

We have, with the help of annual reports from 2005, analyzed IFRS 3 Business combinations. We are interested in the companies' understanding regarding this standard. We want to investigate the reasons why companies assigned a certain part of the total net acquisition cost to goodwill.

1. Please describe your own background and for how long you have been working within the current business segment.
1. In what way does it affect your organisation when new rules and regulations are introduced? Is there usually an uncertainty regarding the interpretation and application of new regulations?
2. Regarding IFRS 3, is it more or less difficult to follow in comparison to other standards? What are your thoughts about the transition phase and the introduction of the new standard?
3. IFRS and IAS are now mandatory for quoted Swedish companies. How have the changes in regulation affected your way of working with disclosures of assets in the event of acquisitions?
4. What accounting method regarding handling of acquisitions do you find the most reliable? The prior method with early amortizations or the newly-introduced one with impairments?
5. What are your opinions regarding the disclosure requirements in IFRS 3? Could you please describe the reasons to why your allocation of acquisition cost was effected in a certain way?
6. Regarding intangible assets, how do you identify and value these? How is a valuation actually effected? Do you use external valuation experts or do you realize the valuation on your own?

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