Informative Value of Goodwill Impairments in financial statements

Case study: Finland

Masters in Finance and Accounting
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Executive Summary

More and more companies are performing aggressive merger and acquisitions strategies in the markets nowadays. With more mature western markets it is often the fastest way to show growth for companies. The rising amount of business combinations leads in combination of IFRS accounting standards, where the straight line amortization of goodwill is not allowed, to bigger and more inflated balance sheets of the companies in form of capitalized goodwill.

Depending on the source and definition of successful business combination 60-90% of M&A activities fail to create expected shareholder value. This makes the research of M&A, goodwill and goodwill impairments a popular topic to study. While the problems have been identified by European Securities and Markets Authority (ESMA), no long term solution can be foreseen at the moment to the problems of goodwill accounting.

This research looks into the informative value of the financial statements of the Finnish companies that are reporting under IFRS accounting standards and thus subject to capitalizing and impairing the goodwill. The research also looks in to the stock market reaction on an announcement date as a predictor of the subsequent goodwill impairment as well as if the indicators could be found that link the goodwill impairment to the failure reasons of M&A derived from the literature.

Research was conducted by analyzing financial statements and information provided in those for the 28 companies that recorded goodwill impairment losses between 2005 and 2012 in their financial statements. The goodwill impairments related to discontinued operations or sale of the assets that goodwill was related to have been excluded from the sample.

The stock market reaction was derived by calculating the abnormal equity returns on the seven day event window and the linkage to the M&A failure reasons were looked by in-depth study of the financial newspapers and how they reported the business combination. Ten companies were selected to in-depth case study analysis based on where the goodwill impairment could be linked to the preceding business combination.

The research concludes that the information given by the companies in the financial statements is highly variable and a lot of important information is missing or presented in a very unclear manner. The IFRS 3 Business combinations has not been able to produce more transparent and comparable information in the financial statements in the research period.

The connection between the initial stock market reaction and the subsequent goodwill impairment could not be made. According to analysis of data, it seems that companies tend to time their impairments of goodwill to the years when the revenue has decreased compared to earlier years. This suggests that the big bath accounting is widely used. However the goodwill impairments were done on the time of economic downturn and it is debatable if the similar pattern can be seen during the economic growth period.

Researcher urges the ESMA in co-operation with the local authorities and IASB to review the standards and to implement tighter and clearer set of rules in order to increase the informational value of the disclosures regarding the goodwill impairments.
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Foreword

“.a scientist must also be absolutely like a child. If he sees a thing, he must say that he sees it, whether it was what he thought he was going to see or not. See first, think later, then test. But always see first. Otherwise you will only see what you were expecting. Most scientists forget that.” (Adams, 1985)

This thesis is dedicated to my family, my loved ones and to those who believed in me during the research process when I was in doubt. The amount of support I have gotten has been truly amazing and I could have not completed this project without the support and encouraging words I received from my family, my friends and my peers.

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Jani Wahlroos
1. Introduction

This chapter will kick off introducing the thesis topic. After that it will align the main concepts of the research as well as shortly introducing the purpose of the research. The purpose of the research is to find out what is the informational value of goodwill impairments in the financial statements. The research was carried out to Rotterdam Business School Research Center of Business and Innovation. The thesis sponsor was Mrs. Lycklama a Nijeholt.

The reason why it is interesting to investigate mergers and acquisitions as well as goodwill impairments in the financial statements of companies is the expectations of a future merger wave coming after the economy raises its head again from the credit crisis of 2008.

To understand how goodwill is capitalized to the balance sheets of companies it is very important to understand underlying economic theories and how the goodwill arises to the balance sheets of companies. Only after that understanding has been formed, a more detailed view to the goodwill impairments can be formed. IFRS 3 requires business combinations to record the purchase price over the net assets of the acquired company to be capitalized as goodwill in to the balance sheets of the companies.

The goodwill impairments under IFRS accounting standards is a popular topic to study at the moment. Several studies have been made regarding the topic, as it is one of the hot topics in finance at the moment. More and more companies pursue aggressive M&A strategies in order to grow. This leads to a rise of goodwill in the companies’ balance sheets. Goodwill is an asset with infinite life and thus will not be amortized on straight line basis. It is interesting to see how much and how accurate information companies provide regarding their goodwill impairments as well as to define the possible reasons for goodwill impairments.
1.1 Context of the research

After the sixth wave of merger and acquisitions in 2003 to 2008, it has become increasingly popular to study the mergers and acquisitions, and whether or not they are creating any value for the shareholders. In 2006 the value of European companies acquired was almost 130% higher than the year 2005 for the first three months. In the latest wave of mergers and acquisitions the value of the deals was getting bigger and bigger. (Economist Print edition, 2006)

There is a seventh wave of mergers and acquisitions expected to start when the economy starts rising again from the banking crisis of 2008. Those effects of the crises can be still seen as a slowed down worldwide economic development. The wave is expected to hit hard in the BRICS countries (KPMG, 2011) and as most of them follow the IFRS accounting standards it is a hot topic in the field of finance and accounting to research the mergers and acquisitions in countries that follow IFRS to come up with conclusions how the merger and acquisition activities effect the companies’ balance sheets and income statements in form of goodwill and goodwill impairments. In addition it is interesting to see how well the companies follow the IFRS requirements about the disclosure for goodwill impairments in their financial statements.

The researcher decided to work on a more academic topic for the Rotterdam Business School Research Center of Business and Innovation. The study will be conducted under the supervision and guidance of Mrs. Lycklama à Nijeholt of Rotterdam Business School. Mrs. Lycklama à Nijeholt has extensive knowledge of the topic, she has written her PhD about the “Goodwill and Value Creation of Acquisitions” and she is doing extensive research on the topic of goodwill and mergers and acquisitions in a co-operation with master’s students of Rotterdam Business School. The Research Center of Business and Innovation of Rotterdam is considered to be an actual real-life organization as defined in the Master’s thesis guide 2013.

The problem owner defines the intention for this research to be based on the failure of mergers and acquisitions and the fact that according to Harvard Business review 90-70% of mergers and acquisitions fail in terms of creating value to the shareholders. (Christensen). The research aims to find out 1). How the goodwill impairments are reported in the financial statements of the selected companies, 2.) if the adoption of IFRS accounting standards in Finland resulted in providing better information for the readers of financial statements regarding the reporting of goodwill impairments and 3). If there are any indicators that can be used to predict the goodwill impairments based on failure reasons for M&A activity derived from literature.

The companies are required to summarize in their notes of financial statements their accounting policies, including goodwill accounting. They are also required to explain the assumptions and accounting techniques used for the goodwill impairment. (Nandakumar, 2010). It is interesting to see if the goodwill impairments are explained in the notes of the financial statements as well as to see if the companies are disclosing the required data in their financial statements.

As derived from above it can be formulated that the purpose of this research is to look into and provide a detailed view of the goodwill impairments in the Finnish markets after the 6th wave of mergers and acquisitions as well as if the stock market can predict accurately the failure of
business combination based on abnormal equity returns around the date of acquisition announcement. The research will look into how the goodwill is impaired in theory and furthermore looking into the reasons and informational value given in the financial statements of the acquiring companies in post mergers and acquisitions based on the IFRS accounting system (IFRS3: Business combinations, IAS 36 and 38). Furthermore the research will look into how accurately stock market can predict the success or failure of a business combination.

The thesis will be done by looking at 28 companies that had goodwill impairments after the 6th wave of mergers and acquisitions in the years 2005-2012 in the Finnish markets and that are listed in OMX Helsinki stock exchange. The aim of the research is to look into the informative value of the financial statements regarding the goodwill impairments for companies that report in IFRS reporting standards. Consequently the thesis aims to look in to failure reasons derived from literature and linking them to the following goodwill impairment based on the stock market reaction around the date of announcement of M&A activity. Ten companies were selected for further case studies, where the M&A activity could be linked to the subsequent goodwill impairment.

1.2 The problem statement

ESMA (European Securities and Markets Authority) issued a call for improvements in disclosures related to goodwill impairment at 21.01.2013. In their research they found out that “the major disclosures related to goodwill impairment testing were generally provided, in many cases these were of the boilerplate variety and not entity specific.” (European Securities and Markets Authority, 2013). Furthermore KPMG summarizes to problems as: “The report raises questions as to whether the level of impairment in 2011 financial statements appropriately reflected the effects of the financial and economic crisis and the difficult economic operating environment. It also raises concerns about the robustness of impairment testing and the transparency of disclosures about the underlying assumptions used” (KPMG, 2013). Taloussanomat, a leading Finnish financial newspaper expected several goodwill impairments in the upcoming years in their forecast at 2008 in Finland, backed up by the interviews with KPMG. (TalousElama, 2008)

As there are underlying problems, The Research Center of Entrepreneurship and Business Innovation of Rotterdam Business School is in need of a study that examines the informative value of financial statements regarding the goodwill impairments of the companies that are reporting under IFRS. Furthermore it is interesting to see what kind of explanations the companies provide in the financial statements regarding the goodwill impairments and examine if the failure reasons for M&A activities derived from literature can be linked to the following goodwill impairment.
1.3 Research objective

The research objective of this thesis is to investigate (1) How the publicly traded companies in Finland that are reporting in IFRS explain the goodwill impairments in their financial statements, (2) if the IFRS reporting standards have increased the comparability and transparency of financial statements regarding goodwill impairments, and (3) if the stock market is predicting correctly the success of M&A activities and if those can be linked to the failure reasons derived from literature.

1.4 The research questions

The researched questions are aimed to solve the problem defined earlier in the problem statement. The questions are formulated so that they are specific, measurable, achievable, realistic and timely.

1. What is the informational value of the goodwill impairments in the financial statements of Finnish companies that are reporting under IFRS?

   a. How well do these companies comply with the requirements of IFRS disclosure in their financial statements?

   b. Has the IFRS3, IAS36 and IAS38 accounting standards improved the usefulness of financial statement information in Finland for the readers of the financial statements regarding the goodwill impairments?

2. Is there a connection between the stock market reaction (deemed success or failure) around the acquisition announcement date and the subsequent goodwill impairments by the business combinations in the Finnish markets in mergers and acquisitions (2005-2011) for the companies that the acquiring company is publicly traded, including cross border acquisitions and that follow the IFRS accounting standards?

The below illustration shows the main data sources used and the general design of the research project.
1.5 Summary

To summarize the chapter it starts with the introduction of the research and explained the reasons why the research was made. The chapter presents the context of the research: To find the informative value of financial statements under IFRS accounting standards as well as to search the connection between the common failure reasons of M&A activity and following goodwill impairment and to see if the stock market can predict the failure or success of the business combination.

Consequently the research questions were formed to provide an answer to the problem, introduced in this chapter. The questions were formed to be SMART. Furthermore the visual aid to understand the research design was presented in this chapter; showing the main theoretical background as well as the conceptual design and what are the main points affecting the research.

Now that the context of the research, problem statement and research questions have been clarified the thesis will move on to literature review to provide the reader good overall understanding about the economic theories that underline the reasons behind Mergers and acquisitions as well as the main accounting standards defined by IASB relating to the recognition of goodwill in balance sheets, impairment testing and eventually the disclosures of financial statements required by IFRS 3.
2. Theoretical Background

2.1 Introduction

After the introduction and problem statement as well as the research questions were explained in the first chapter it is time to move on to develop understanding of the theoretical background of the problem. In this chapter the theoretical background for the research is presented. The chapter is divided into two parts: Mergers and acquisitions and accounting of mergers and acquisitions under IFRS. In research of goodwill impairments it is vital to understand the concept of goodwill as internally generated goodwill is not recorded to the balance sheet. Moreover it is in high importance to understand how it arises and what are the common motives for the M&A activities.

The chapter starts with the introduction of mergers and acquisitions. Then it will take the reader to definitions of mergers and acquisitions and presenting the common types of mergers and acquisitions. The subchapter is divided into four parts – general information about mergers and acquisitions, the motivations, including the good, the bad and the ugly reasons for business combinations. Then the attention is paid to defining the value for the shareholders and the introduction of the concept of abnormal equity returns used to measure the stock market reaction in an event window.

After defining the concepts that leads to goodwill to be capitalized to the balance sheets of the companies the attention is paid on the goodwill itself. The goodwill is first defined using economic definition and then the accounting definition. Consequently detailed view is presented to IFRS 3: Business Combinations, which defines the accounting treatment of M&A activities. After that the attention is brought to IAS 36 – impairment of the assets and IAS 38 Intangible assets. Those two standards are essential in defining the accounting of goodwill and disclosures required in the financial statements. Finally the impairment testing is introduced on general level and after that the risks associated with goodwill are discussed as well as recent studies from reputable sources regarding the goodwill impairments are presented.

The aim of the theoretical background is to provide the reader sufficient theoretical knowledge to understand the essential concepts of mergers and acquisitions and goodwill accounting including the impairment testing as well as to define the terminology and regulations and guidelines in International Financial Reporting Standards.
2.2 Mergers and acquisitions

2.2.1 Mergers and acquisitions defining the concepts

Mergers and acquisitions can be defined as a transaction where two or more companies are combined to achieve certain strategic and business objectives. Mergers and acquisitions are of great significance not only to companies themselves but to many other constituencies, such as workers, managers, competitors, communities and in the bigger mergers and acquisitions for the whole economy. (Sudarsanam, 2003)

To distinguish between the mergers and acquisitions it is important to go through the terminology in the beginning. Acquisitions occur when one company takes a controlling ownership interest in another company, a legal subsidiary of another firm, or selected assets of another company, such as a manufacturing facility. An acquisition may involve the purchase of other company’s assets or stock, with the acquired company continuing to exist as a subsidiary company of the acquirer. (DePamphilis, 2008)

Miller distinguishes three basic ways to structure a merger or an acquisition. First one is stock purchase, where the outstanding stock of the target is sold to the buyer (acquiring company) by the shareholders of the target company. In practice this is done via the tender offer, in which the acquiring company makes a formal public offer to the target’s shareholders. The second one is merger, where the target is merged, pursuant to the legal requirements of the applicable state. Merger are used in public companies because they have a large amount of shareholders and it is not feasible for all of the shareholders to sign a stock purchase agreement. The main difference between merger and stock purchase acquisition is that in merger the two or more companies agree to merge while in stock purchase the stock is being bought off from the current stockholders. The third basic structure is an asset purchase, where selected portion of the asset(s) is sold to another company. (Miller, 2008)

In general a merger is a combination of two or more firms in which all but one legally cease to exist, and the combined organization continues under the original name of the surviving company. (DePamphilis, 2008) In a typical merger shareholders of the target company are exchanging their shares for those of the acquiring company. Acquisition is slightly different from merger in a sense that in acquisition the company continues to exist as a company on its own or as a subsidiary of acquiring company.

2.2.2 Horizontal, vertical and conglomerate mergers and acquisitions

Mergers and acquisitions can be defined to three different categories based on the operating businesses the companies are in. Horizontal merger refers to a situation where the both companies of business combination are in the same line of business. (Brealey, Myers, &
Examples of horizontal acquisitions include Procter & Gamble and Gillette (2006) in household products. Vertical mergers and acquisitions on the other hand involve two companies at different stage of production. The buyer might be expanding back towards the source of raw materials or forward in the direction of the ultimate consumer. (Brealey, Myers, & Allen, 2011)

The third classification is the conglomerate merger, which refers to a situation where an acquiring or merging companies are in totally different lines of business. These usually involve companies’ management trying to reduce the risk by the means of diversification. (DePamphilis, 2008)

### 2.3 Motivations for Mergers and acquisitions – The Good, the Bad and the Ugly

There are numerous theories why mergers and acquisitions take place. In reality most of M&A’s are a result of a number of different motives. These theories can be divided in to positive and negative reasons. While this thesis considers the negative theories more in detail, it is important to keep in mind that it is very hard to distinguish a sole reason or a motivation for a merger or acquisition. (DePamphilis, 2008)

#### 2.3.1 Economic synergies – The Good

The economic perspective of mergers and acquisition is concentrating on value creation through economies of scope and scale. (DePamphilis, 2008) As mentioned above M&A activities from economic perspective can be classified as horizontal, vertical or conglomerate mergers. How a merger is classified depends on whether the merging firms are in the same of different industries and on their positions in the corporate value chain. (Porter, 1985)

Synergy is a rather simplistic notion that the combination of two businesses can create greater shareholder value than if they are operated separately. (DePamphilis, 2008) The aim of the business combination is naturally to create shareholder value, thus the M&A activities are usually reasoned with synergies that it will create. However the synergies seen by the business combination management are not always lines with the stock market prediction of created synergies. Thus the stock market is usually discounting in their assessment the synergies reported by the management and actual stock price, which is the future value of the company, taking in to account all the available information. (Sudarsanam, 2003)
2.3.1.1 Economies of scale

First of the operating synergies is the economies of scale. Economies of scale refer to situation where the intention of a merger or acquisition is to reduce the costs. (Brealey, Myers, & Allen, 2011) Scale is defined by such fixed costs as depreciation of equipment, normal maintenance spending, and obligations such as interest payments, lease payments, customer and vendor contracts and taxes. Such costs are fixed in a sense that they cannot be altered in a short run. Consequently for a given scale or amount of fixed expenses the euro value of fixed expenses per euro of revenue decreases as an output. (DePamphilis, 2008)

Achieving the economies of scale is the natural goal for horizontal mergers and acquisitions. Such motivations have been also reported for conglomerate mergers, too. Economies of scale can also decrease management expenses as two merging companies do not need two different managements anymore. Economies of scale are typical for single product companies, which aim to achieve cost savings thru a business combination, eliminating the duplicate production facilities or service departments. (Sudarsanam, 2003)

2.3.1.2 Economies of scope

Economies of scope is referring to using a specific set of skills or an asset currently used in production of a specific product or service to produce related products or services. Economies of scope are most often found when it is cheaper, in company’s assessment, to combine two or more product lines in to one than to produce them in separate lines. (DePamphilis, 2008) However, most modern firms are multiproduct companies. In spite of high level of divestures and corporates returning to their core businesses, the extent of diversification is in 500 largest corporates in the US has actually increased over the years. (Montgomery, 1994)

With multiple products companies can achieve economies of scope. Scope economy exists when the total cost of the production and the sales of the same products by the multi-product firm is less than the sum of the total costs of producing and selling products by individual companies specializing in those products. There are several companies that use economies of scope, including big multinationals, such as Unilever, Nestle and Virgin group. Scope economy can also be manifested in the form of increased revenue and profits rather than the unit cost reduction of the individual products in a multiproduct company. (Sudarsanam, 2003) Companies using economies of scope share in common the fact that a specific set of skills or assets are used to generate more revenue by applying those skills or assets to producing and selling multiple products. (DePamphilis, 2008)

Also another part of the economies of scope is improving the target management. Palepu, Healey and Peak note that a firm is likely to become a target for acquisition if it has constantly underperformed the industry average. Historical poor performance could be due to a bad luck, but it could also signal the firms’ management’s poor investment and operating decisions. It could also signal that the management is pursuing its own interests to increase their own power
with the cost of shareholder wealth. (Palepu, Healy, & Peek, 2008) This gives the acquirer an opportunity to replace the management in order to increase the company performance and generate more profits than the replaced management.

2.3.1.3 Capturing tax benefits

Capturing tax benefits is one of the only reasons that will create net gain to the business combination. The major benefit is the acquisition of operating tax losses. If a firm does not expect to make sufficient profits to fully utilize its operating loss carry forward benefits, it may decide to buy another company that is earning profits. The operating losses and loss carry forwards of the acquirer can then be offset against the target’s taxable profits. A second tax benefit worth of mentioning is the tax shield. The interest expense on the additional debt is tax-deductible and lowers the target firm’s tax payments. (Palepu, Healy, & Peek, 2008)

2.3.1.4. Financial Synergies

Financial synergies refer to the impact of M&A on the cost of capital of the acquiring firm or the newly formed firm resulting from the business combination. Theoretically the cost of capital could be reduced if the merged companies have uncorrelated cash flows. It is also possible to realize financial economies of scale from lower securities and transaction costs or as a result in a better matching of investments opportunities with internally generated firms. (DePamphilis, 2008)

Under the assumption that markets are imperfect, in a case of asymmetrical information between management and outside investors, newly found companies can face capital constraints. Usually these companies that don’t have proven track records are very hard for outside investors to value. In these cases, given that the acquiring company understands the business and is willing to provide steady source of financing they might be able to add value by lowering the cost of capital of the target company. (Palepu, Healy, & Peek, 2008)

On the other hand Myers, Brealey and Allen argue that lowered cost of capital for the business combination comes with a cost. Now the merging firms are backing up also each other’s debt. In other words, they get lower interest rate only by giving bondholders better protection and there is no net gain. While it is true that companies can achieve economies of scale also financial synergies are achieved in form of larger and fewer security issues. However when talking about financial synergies, usually it is referred to larger scale, not only to the transaction cost of issuing securities. They continue mentioning that only way mergers can create value by making debt safer is when the other of the merging firms covets interest tax shields but is reluctant to borrow more in fear of financial distress. Merging in this case decreases probability of financial distress other things being equal. This in turn allows increased
borrowing and increased value from the tax shield, so there is actual net gain to the merger. (Brealey, Myers, & Allen, 2011)

2.3.2 Diversification – The Bad

Diversification refers to a strategy of buying companies that are not in the company’s current line of business. The common argument for diversification is for firms to shift from their core markets or product lines into the ones that have higher growth prospects. (DePamphilis, 2008) While it is obvious that diversification reduces the risk of the company, it is much easier and cheaper for stock holders to do it themselves by buying stock of different companies than for corporations. There is little evidence that investors pay a premium for diversified companies. (Brealey, Myers, & Allen, 2011) Quite the opposite actually: empirical studies show that investors are not benefitting from unrelated diversification. The share prices for conglomerates often trade at a discount from shares of focused companies or from their value if they were broken up and sold in pieces by as much as 10 to 15 percent in the United States of America. (Berger & Ofek, 1995). However there is lack of empirical evidence of conglomerates stock trading at discount in continental Europe and India. (Sudarsanam, 2003)

Diversification is often used as a reason for management to reduce their own risk, or the company’s risk they are working for. In this case the diversification relates to empire building theory, discussed later on. It is suggested that managers tend to overpay in these cases of acquisitions, decreasing their own risk. (Lycklama a Nijeholt, 2010)

2.3.3 Agency theory, Empire Building and the management Hubris – The Ugly

2.3.3.1 Agency Theory

Jensen and Meckling developed a model of the firm as a nexus of contracts. Firms receive capital by issuing equity and debt. Shareholders as owners of a company enter a contract with management delegating them the powers of managing the company on their behalf. The managers become agents of the principles, the shareholders. Managers may pursue their own interests instead of shareholders interest destroying the value of the company. The difference between the interests represents the agency cost to shareholders. Where the agency problem is extreme, investors may refrain from investing in the company’s shares, thereby denying managers the resources that would enable them to grow. Incentives for agency theory to arise could be management incentives tied to the certain financial indicators to the company. The management in those cases will consider taking long term value destructive actions to achieve the short term goals and incentives instead of concentrating on long term value creation of the company. (Sudarsanam, 2003)
In mergers and acquisitions agency theory is closely related to empire building and management hubris which will be presented in next chapters.

2.3.3.2 Empire Building

When managers are lacking the good long term incentives and other corporate governance mechanisms are not proper enough, shareholders are exposed to the risk of empire building management. The management incentives are often tied to the certain performance indicators of companies and their benefits increase with the size of the company. The swiftest way to increase the size of the company is thru M&A activities and thus managers are more likely to involve in business combinations for fast growth. Companies that are subject to large free cash flows for equity owners are more likely to get engaged in empire building. Instead of paying the cash flows to shareholders in form of dividends, managers have incentives to use excessive cash to take on M&A activities that turn out to be value destructive. (Lycklama a Nijeholt, 2010)

However it is very hard to distinguish or provide evidence regarding the empire building. While there are certain indications that can be calculated from financial statements, they only indicate the empire building: They do not act as a prove of it.

Managers in companies with high free cash flow have temptation to overinvest and furthermore managers can use business combinations as a short term solution to satisfy market expectations of growth. The engagement in M&A activity will create an illusion of growth, even in long term it seems to be unsuccessful. (Investopedia, 2013)

2.3.3.3 Management Hubris

Management hubris theory lays its base in the managerial psychology. Richard Roll suggested in 1986 that urge to merge is driven by pride, or hubris, under the evidence that earning abnormal returns from M&A activities is very difficult. It is well known that more than often M&A activities are value destructive. Only an irrational belief that your deal will be successful could prompt you to attempt to be winner where so many others have lost. (Bruner, 2004)

Hubris hypothesis in M&A activity says both, too much and too little. It says too much in a sense that hubris theory could be used to explain the failures in most business combinations (around 70% of M&A activities fail to create value). Almost all of the M&A activities could be explained on basis of management hubris. On the other hand Hubris says too little in a sense that it does not have more prescriptive content. The theory urges to avoid managerial irrationality and warns that if we don’t markets will judge accordingly. (Bruner, 2004)
Also the critics of the hubris theory note, that if hubris was the dominant reason for business combinations it would need to explain the appearance of merger waves and the clustering of M&A activities by sector. It cannot be assumed that managers with tendencies to hubris or empire building would only be found on certain industries and certain times. (Bruner, 2004)

2.4 Defining value for shareholders

According to finance theory perspective, managers’ decisions are aimed at enhancing shareholder wealth. As discussed before this is not always true in the case of mergers and acquisitions as the reasons for M&A often have negative impact on shareholder value. If we can show that shareholders are better off with the acquisition then this test for finance theory is successful. Technically this means that the return stockholders earn from investing in the acquirer’s stock is at least equal to the cost of capital. If an acquisition fails and the shareholders would have been better off with investing their capital in another investment opportunity, say, a better performing company with less aggressive acquisition strategy. (Sudarsanam, 2003)

While conceptually simple, the above test poses several conceptual issues. The most significant problem is the benchmark problem. To what the acquiring companies return should be compared to? There is no two same companies, one acquiring and other one not in the world, so picking accurate benchmark from an external similar company is impossible. (DePamphilis, 2008) Forecast performance can be also used as a benchmark, however forecasting the cash flows of a company and discounting them to present value poses several problems as well. We do not possess the ability to predict future and there are several other factors that have big impact on the company, such as economic condition of the world, technical breakthroughs etc. which have bigger impact on company value than the previous merger or acquisition activities. (Sudarsanam, 2003)
2.5 Abnormal equity returns

In event studies, such as merger and acquisition, it is common to adjust the returns measured on the event date for the normal returns. The resulting returns are known as abnormal returns. The normal return is the expected return as if the event did not take place. The normal return can be calculated using the CAPM model, developed by Harry Markowitz based on the portfolio diversification theory. Brown and Warner (1985) reported three different ways of adjusting for normal returns: 1. the mean adjusted return model, 2. the market adjusted returns and 3. The OLS market model. (Lycklama a Nijeholt, 2010)

1. The mean adjusted return model:

\[ A_{i,t} = R_{i,t} - E[R_i] \]

Where \( t \) is the event date, \( R_{i,t} \) is the return on the event date and \( E[R_i] \) is the mean return in the period before the event date. The period before the event date is also known as the estimation window.

2. The market adjusted model

\[ A_{i,t} = R_{i,t} - R_{mj} \]

Where the \( t \) is the event date, \( R_{i,t} \) is the return of the specific company’s stock the event date and \( R_{mj} \) is the return of the stock market as a whole. By deducting the stock market return from actual return on an event date, the abnormal return on an event date, \( A_{i,t} \) is derived. For the purposes of the thesis the return of the stock market for this formula is derived from OMX Helsinki index.

3. OLS market model

\[ E[R_{i,t}] = \alpha_i + \beta_i R_{mt} \]

Where \( \alpha_i \) and \( \beta_i \) are estimated parameters of regression. Alpha and beta are estimated directly by using historical relationship. While this method relies on an estimated stock return of the company \( i \) and requires linear regression analysis of company \( i \)’s daily stock return it will not be used for the purposes of this thesis. (Sudarsanam, 2003)

As a conclusion the market adjusted model will be used for the purposes of this thesis. While the abnormal equity returns is used to define the stock market reaction, deeming the M&A activity as a failure or success, it is feasible to use the mean adjusted model as it takes in to account the movement of the market as a whole comparing it to the event returns.
2.6 Accounting of Mergers and acquisitions

2.6.1 Introduction to the accounting of Mergers and Acquisitions

As the businesses around the world are more and more technology orientated the accounting of intangible assets has become a major issue with many companies. The movement towards technology driven businesses has triggered the IASB to issue new set of rules to comply in the case of business combinations – IFRS 3. IFRS 3 came in to effect at 2004 with the revised version of IAS 36 and IAS 38. The following chapters will begin with defining the concept of goodwill, then moving on to IFRS 3, business combinations and shedding some light to the IAS 36 and IAS 38 to develop an understanding of the regulations around the goodwill accounting. After that goodwill impairment test will be summarized. Also the chapters following will look in to purchase method of accounting that is required to use by the IFRS 3.

2.6.2 Goodwill defined

The goal of this chapter is to define what goodwill means in economic sense as well as in accounting sense. The IFRS 3, business combinations will be used as a guideline to define goodwill in accounting sense.

Generally accepted and agreed definition for goodwill has not been formed yet. The terminology of the goodwill dates back to the end of 19\textsuperscript{th} century. At the year 1882 Bathell wrote that the goodwill is that amount, that owner of the company would be willing to sell the company to some other party. At the beginning of 20\textsuperscript{th} century, Yang mentioned that goodwill is formed by mergers and acquisitions and must be measurable in monetary value. (Seethraraman, Balachandran, & Saravanan, 2004)

Existence of goodwill is related to immaterial rights of a company, such as brand, name of the company, knowledge, and location. The common nominator for these apart from being immaterial rights is that, if one of them will be taken out from a company the value of the company will be diminished. Goodwill is an intangible asset that is very hard to measure. It can be anything (intangible) that the acquirer will pay for in a business combination higher price than the net assets of the acquiree. Another common nominator is that goodwill cannot be separated from the company nor it can be sold or purchased separately. (Seethraraman, Balachandran, & Saravanan, 2004)

Investing guru Warren Buffet defines goodwill as: "Businesses logically are worth far more than net tangible assets when they can be expected to produce earnings on such assets considerably in excess of market rates of return. The capitalized value of this excess return is economic goodwill." Economic goodwill can be defined as an intangible asset that is outside of balance sheet. In IFRS this means all the internally generated goodwill – which is not seen on
the financial statements of the company. Buffet’s investment strategy is based on concept of economic goodwill. Economic goodwill can be customer base, brand name or low cost production. The theory of economic goodwill is based on durable competitive advantage of a business. (Emerson, 2011)

Goodwill can be of two types. Goodwill can either be internally generated or purchased. Goodwill is said to be internally generated when a firm earns super profits. On the other hand, purchased goodwill is a result of merger and acquisition activities. However, goodwill is accounted only when a business is purchased or sold. Internally generated goodwill cannot be capitalized to the balance sheet of the company. (Arnold, Egginton, Kirkham, Macve, & Peasnell, 1992)

According to Arnold, Egginton, Kirkham, Macve and Peasnell, the public has assumed the importance of goodwill just recently. In its earlier definition goodwill just meant customer loyalty. They attribute two main reasons for the increase in goodwill’s importance. First is the increase in merger and acquisition (M&A) activities in the market and second is the rising stock market. This has created a wide gap between the book value and market value and also between the fair value and paid value of assets of a firm. As a result, the increasing importance of recognition, valuing and accounting of goodwill was widely felt. (Arnold, Egginton, Kirkham, Macve, & Peasnell, 1992)

From the accounting point of view goodwill can be defined as following:

1. Fair value of consideration paid
   +
2. Fair value of non-controlling interest
   -
3. Fair value of identifiable assets
   =
   Goodwill

In short we can say that everything that is not identifiable as a separate asset or liability is considered goodwill. This goodwill is formed by the overpayment (or underpayment) over the fair value of assets and liabilities purchased. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)

To summarize goodwill can be found from the acquiring company’s balance sheet under the intangible assets. Goodwill is formed by the intangible assets that do not fulfill the requirements of assets or liabilities and thus cannot be booked as any other asset. Goodwill is representation
of possible future benefits gained from synergies of business combinations. In a business combination some of the most commonly named reasons for goodwill are increase in market share, acquisition of knowledgeable employees and new networks gained from a purchased business.

2.6.3 IFRS 3 Business combinations.

This chapter will summarize the IFRS 3 – business combinations standard issued by IASB at 2004. In IFRS 3 the pooling method of accounting for business combinations was removed following the guide set by US-GAAP at 2001. In the pooling method no goodwill was capitalized to the balance sheet. IFRS 3 only allows the accounting of business combination with acquisition method resulting vast amounts of goodwill in the balance sheets of acquiring companies.

The following chapters are paying consideration to the most important parts of International Financial Reporting Standards regarding the goodwill accounting. This includes the impairment of the assets, intangible assets and the impairment testing of assets. After that a separate chapter will look in to the goodwill impairment. Finally risks of goodwill are discussed and some previous studies considered.

2.6.3.1 IFRS 3 – Requirements for business combinations

IFRS 3 Business Combinations outlines the accounting when an acquirer obtains control of a business (e.g. an acquisition or merger). Such business combinations are accounted for using the ‘acquisition method’, which generally requires assets acquired and liabilities assumed to be measured at their fair values at the acquisition date. IFRS 3 became effective on 1st of April 2004. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

A revised version of IFRS 3 was issued in January 2008 and applies to business combinations occurring in an entity’s first annual period beginning on or after 1 July 2009. (Deloitte, 2013)

Mergers and acquisitions are common examples of business combinations. The business combinations are covered in IFRS 3, Business Combinations. The objective of IFRS 3 is to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)
IFRS 3 defines the principles and requirements for how the acquirer

1. Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquire
2. Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase
3. Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

A business is defined in IFRS 3 as “an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants”. This definition by itself excludes the asset acquisitions as they do not fulfill the definition of business. In this thesis only mergers and acquisitions that fulfill the definition of Business combination as derived from IFRS 3 are considered. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

2.6.4 Impairment of the assets – IAS 36

IAS 36 – the impairment of assets is the main accounting guideline to be presented in this chapter. The aim and scope of the standard are definitions, identification of the asset that might have lost value and thus should be impaired, future cash flow valuations of assets and defining as well as recording the impairment losses. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)

Impairment loss can be defined as the value that an assets carrying amount exceeds its recoverable fair value. In other words the future cash flows from that asset are lower than the book value of that particular asset. Freely formed the standards main goal is to ensure that the assets book vale does not exceed the assets’ recoverable amount. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)

Price Water House Coopers summarizes the IAS 36 standard as following: “Impairment of Assets sets out the procedures that an entity should follow to ensure that it carries its assets at no more than their recoverable amount. Recoverable amount is the higher of the amount to be realized through using or selling the asset. Where the carrying amount exceeds the recoverable amount, the asset is impaired and an impairment loss must be recognized. The standard details the circumstances when an impairment loss should be reversed, and also sets out required disclosures for impaired assets, impairment losses, reversals of impairment losses as well as key estimates and assumptions used in measuring the recoverable amounts of cash-generating units (CGUs) that contain goodwill or intangible assets with indefinite lives.” (PriceWaterhouseCoopers, 2009)
IAS 36 defines as well the notes that need to be disclosed for the financial statements regarding the impairment of assets. (Appendix 2.)

IAS 36 applies to assets, which are not subject to the more detailed recognition or booking guidelines provided by IFRS. Assets that are in the scope of the IAS 36 impairment are property, plant and equipment, intangible assets such as goodwill, investment properties and investments in subsidiary, associate or joint companies. The IAS 36 requires a write down of an asset even if the impairment is temporary in nature to ensure the fair value accounting. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

2.6.5 Intangible assets IAS 38

The intangible assets are dealt in the IAS 38 – standard, intangible assets, issued by IASB. The intangible assets refer to identifiable non-monetary assets that do not have a physical substance. The identifiability concept of an intangible asset is met when it is separable. (so in other words it can be sold, transferred or licensed to another party) or when it is based on a contract or other legal right. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009).

The KPMG defines the objective of the standard as: “The standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognize an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.” (KPMG, 2010)

Intangible assets are amortized when the useful life of the asset is identifiable. The amortization of intangible assets with identifiable useful life is systematic just like the depreciation of tangible assets. The useful life of an intangible asset is considered unidentifiable when all the relevant factors in the analysis point that there is no possibility to estimate the timeline when the intangible asset is generating net cash flows. These intangible assets that have infinite useful life are subject to the impairment test as defined in IAS 36. Impairment test is done yearly (it is mandatory to test at least once a year) or whenever there is evidence that the asset is not valued at its fair value. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)

IFRS includes a detailed guidance on when the intangible assets should be valued and impairment testing needs to take place, how to book the accounting entries to the assets and when previously impaired asset can be capitalized in case of the temporary impairment. Goodwill however can never be temporary booked down and later reversed. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

According to IFRS 3 – business combinations there will be no amortizing of goodwill or other intangible assets with infinite useful life. Thus goodwill is always subject to the IAS 38 and impairment testing.
2.6.6. Impairment testing

According to IFRS 3 goodwill is no longer amortized in accordance with the old practice of systematically amortizing goodwill. Instead the companies are required to test the goodwill for impairments on regular basis. Usually this is done once a year, but IFRS 3 requires test to be done whenever it is necessary or conditions point to the way that impairment should be done. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)

PWC summarizes the impairment test as: “At the end of each reporting period, entities must consider whether there are indicators that suggest their assets are impaired. If such indicators exist, the asset must be tested for impairment by comparing its carrying amount with its recoverable amount. If the asset is impaired, the entity must write it down to its recoverable amount and recognize an impairment loss in the statement of comprehensive income. The only exception is if the impaired asset is a revalued asset. In this case, the value changes are recognized directly in equity to the extent that a revaluation surplus for that asset exists in equity.” (PriceWaterhouseCoopers, 2012)

Company must assess at each book closing date whether or not there is indication that an asset might be too highly valued and thus impaired. If any indication exists for the impairment after assessment the impairment test and following impairment must be made. Even if there is no such indication to the company that impairment of assets is due, the companies are still obliged to evaluate annually following assets: goodwill, intangible assets with indefinite life as well as unfinished intangible assets. Impairment is looked at the point of view of cash generating units, which are the smallest units, that generate net cash flows and which cash flows are separable from the other cash flow generating units. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

It is not mandated to make the impairment test at the book closing date, but it is advised that the impairment test is done on yearly basis consistently on the same time of the year. The natural timing for the impairment test is around the same time as the budgeting and forecasting for next year. In this case the impairment test is done based on the most recent vision of company's management and their expectations of the future developments of the business and plans for the future. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

To test an asset for impairment, the recoverable amount of the asset needs to be measured. An asset’s recoverable amount is the higher of its fair value less cost to sell (FVLCTS) and value in use (VIU), the latter being the present value of future cash flows expected from using the asset. Most assets in a business typically generate cash inflows by working together as a group of assets rather than generating cash flows individually. As such, it is often impossible to measure an individual asset’s VIU. This means that unless the asset’s FVLCTS is greater than its carrying amount, the asset must generally be tested for impairment as part of the VIU of the cash generating unit to which it belongs. (PriceWaterhouseCoopers, 2012)

Companies are obliged to assess if there is any indication that an asset needs to be impaired. The company must take in to consideration both, internal and external factors that might have impact on their business. External factors that might have impact on impairment to mention few are: decline in the market value of property or intangible asset, the company’s operating market has changed or is changing, the net value of company’s assets is higher than the fair market value. Other factor is a raise in inflation or interest rates, which have effect on
discount rate used for value in use calculation. Internal information that needs to be evaluated for the impairment testing are for example indication that the asset is outdated, damage to the property, or the operations that the asset is part of will be terminated. Internal reporting, such as forecasts might show indications that the profitability of the asset is worse than expected. (Ankarath, Ghosh, Mehta, & Alkafaji, 2010)

The impairment test needs to be executed even when the indication for impairment test is based on the management information obtained from other external sources. In other words the impairment test needs to be done immediately when there is an indication that the fair value of the asset is lower than its accounting value. The test assesses how much of the book value of an asset is recoverable at that moment of time. The recoverable amount is the amount of cash that company can expect to gain from the sale of that asset in arms-length trade or the company can profit from the use of that asset based on discounted cash flow valuation model, also known as value in use. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)

An impairment loss is recognized when the asset’s carrying amount is greater than its recoverable amount or in other words it’s fair value. Loss is recognized in the income statement immediately when the impairment test indicates that impairment is necessary. In case of goodwill the impairment loss must be recognized to the cash generating unit that the goodwill was allocated to. If the estimates used to determine the asset’s recoverable amount have changed, the company can reverse the impairment loss. However this does not apply to goodwill and goodwill impairments may never be reversed under any circumstances. (Global Accounting Consulting Services team of Price WaterhouseCoopers LLP, 2009)

The companies are required to perform the impairment test annually. However there are certain criteria that need to be met in order to use last year’s valuation. Ernst and Young in their impairment guide define the rules as following: “The entity may re-use previous periods’ impairment calculations for intangible assets with indefinite useful lives and for goodwill that forms part of a CGU, or group of CGUs, when all of the following criteria are met:

✓ The assets and liabilities comprising the CGU, or group of CGUs, have not changed significantly since the most recent calculation of recoverable amount.
✓ The previously calculated recoverable amount exceeded the carrying amount by a substantial margin.*
✓ The likelihood that an updated calculation of the recoverable amount would be less than the CGU’s, or group of CGUs’, carrying amount is remote.

The standard allows this impairment test to be performed at any time during an annual period, provided the tests are performed at the same time every year. Different CGUs may be tested for impairment at different times. Entities should determine the optimal time for assessing individual CGUs based on the availability of data — considering, for example, the availability of forecast or budget figures, the potential seasonality in a business or the year end close timetable — and use that date in future years” (Ernst & Young, 2010)
2.6.7 Goodwill Impairment

According to PWC’s guide to impairments goodwill doesn’t generate cash flows independently of other assets or groups of assets; rather, it contributes to the cash generation of multiple CGUs. To test goodwill for impairment, it must be allocated to the parts of the business expected to benefit from the business combination that gave rise to the goodwill. The level of allocation must be the lowest level at which management monitors goodwill. It cannot be larger than an operating segment. (PriceWaterhouseCoopers, 2012)

For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer’s cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. (IFRS, 2012)

As an example, if the motive for the business combination is to buy out the competition and to create economies of scale for its market, it is mandatory to assess which cash generating units will benefit from the purchase most and goodwill needs to be allocated to those cash generating units. These synergies can be for example purchase or sales agreements available with bigger bargaining power generated from economies of scale, or the from the newly formed business combination has cheaper access to raw-materials or some other factors in production. (Sudarsanam, 2003)

Different cash-generating units may be tested for impairment at different times. However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period. The Standard permits the most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit (group of units) to which goodwill has been allocated to be used in the impairment test for that unit (group of units) in the current period, provided specified criteria are met. (IFRS, 2012)

IAS plus guide for goodwill accounting defines the need for goodwill impairments as: “A cash-generating unit to which goodwill has been allocated shall be tested for impairment at least annually by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit; [IAS 36.90]

- If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit is not impaired
- If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity must recognize an impairment loss.

The impairment loss is allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order: [IAS 36.104]

- first, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
then, reduce the carrying amounts of the other assets of the unit (group of units) pro rata on the basis.

The carrying amount of an asset should not be reduced below the highest of: [IAS 36.105]

- its fair value less costs of disposal (if measurable)
- its value in use (if measurable)
- Zero.

(Deloitte, 2013)

2.6.8 Goodwill impairment disclosures

The disclosures for the goodwill impairments play a major role in transparency and comparability of the financial statements. PriceWaterhouseCoopers has defined the key aspects of the disclosures as: “IAS 36 contains extensive disclosure requirements. Among others, for each CGU that contains goodwill or intangible assets with indefinite useful lives - and for which the amounts of such assets are significant in relation to the entity’s total goodwill or intangible assets with indefinite lives - the standard requires disclosure of:

- The carrying amount of goodwill allocated to the CGU
- The carrying amount of intangible assets with indefinite useful lives allocated to the CGU
- The basis on which the CGU’s recoverable amount has been determined, i.e. VIU or FVLCTS

If recoverable amount is based on a discounted cash flow calculation:

- A description of each key assumption
- A description of how management has determined the values assigned to each key assumption, for example whether the values reflect past experience or, if appropriate, is consistent with external sources of information.
- The period over which management has projected cash flows, using approved budgets and forecasts; and when a period of more than five years has been used, an explanation as to why the longer period is justified
- The growth rate used to project cash flows beyond the period covered by management-approved budgets and forecasts
- The discount rate used in the cash flow projections” (PriceWaterhouseCoopers, 2009)

The full list of disclosure requirements is presented in the Appendix 2.
2.6.9 Risks related to goodwill

When IFRS came mandatory in Finland for public companies in 2004, the goodwill accounting of IFRS was widely criticized. The opponents of goodwill impairment wanted to keep the old amortization method. While it is debatable if the impairment testing is the correct way to go there has been following arguments presented to defend goodwill impairments. The same conclusion came from the expert interview of this thesis, underlying the following good sides of the goodwill impairments:

- The goodwill does not lose value with the time – certainly not with any straight line basis
- It is impossible to define the amortization period for goodwill that would be realistic
- Goodwill is part of an investment and since the investments are not depreciated or amortized goodwill should not be subject to amortization
- Impairment testing provides more realistic picture of real value of goodwill and if it has lost or gained value

The weak side of impairment testing is obviously the information provided. If the companies would be open and transparent on their impairment testing assumptions this would benefit the readers of financial statements hugely. Also from company’s point of view impairment testing done correctly can bring very useful information about the profitability of asset for managerial decision making.

Most critical situation regarding the goodwill arises when companies have more than 50% of goodwill in their financial statements. Another signal for impairment testing validity is when the market value of company is exceeded by its book value (P:B ratio). This is one of the most followed ratios by investors and thus very important for company. It gives a special incentive for management to impair the goodwill when the market value of the company is substantially lower than the book value. (Kauppaheti, 2009)

The opponents of goodwill impairment test usually relate it to the motives of management, incentives and earnings manipulation. At the moment goodwill impairments in most of Finnish companies are done when the management changes. It is widely criticized that there must be a better way for goodwill impairments to be done than changing the management. Also there is lot of evidence that goodwill impairments are not done in the spirit of IFRS in determining the value in use. Usually the impairments are done as a big one time charge, instead of annually in smaller scale. It seems unlikely that the goodwill impairments would occur in such manner. Of course big changes in a market require big impairments. However the timing of these poses a difficult dilemma: Is it really honest or just another mean for managers to pursue their interest in earnings management. (Kalm, 2006)

According to research by Financial Supervisory Authority the major reason for companies not to impair goodwill has been that companies are expecting the profitability of the asset increase in the long run. Even the near future economic situation is not relevant according to management of the company, it is still important that management can argue why the near
future economic situation wouldn’t have impact on the long term return. (Suomen Finanssi Valvonta, 2009)

2.6.10 Big bath theory

Big bath theory is an earnings management technique that refers to a situation when a one-time charge is taken against the earnings in order to reduce assets resulting lower expenses in the future. The impairment of an asset from the balance sheet will result a lower net income for the period when the impairment is made resulting lower funds available for shareholders on that year. The objective of the big bath theory is to take one single bad year to increase future profitability.

The big bath technique is often used on a year when the revenue is down from other external factors and the company would report a loss or decreased profitability in any case. Companies will often wait for the bad year before doing the big bath to clean up the balance sheet. The process is highly discouraged by the auditors, but it is still widely used. (Bazley & Jones, 2010)

Companies remain competitive by regularly assessing the efficiency and profitability of their operations. However it gives rise to problems, when readers of financial statements see a large charges associated with big one time impairments. These impairments help companies to “clean up” their balance sheets, giving them a big bath.

Why are the companies so tempted to overstate these impairment losses then? When earnings take a big hit, the theory says shareholders will look beyond a bigger one-time loss and focus only on the future earnings. (Gibson, 2012)

2.6.11 Recent studies and empirical findings about goodwill impairment

In this part the recent studies regarding the goodwill impairments and disclosures in financial statements will be presented. Goodwill has been increasingly popular topic to study recently and there is huge amount of data available regarding different kind of studies. Here the focus is on the research by reliable sources, such as financial authorities, big four companies and expert journal articles.

Esma studied 235 statements of companies with significant amount of goodwill. As a result they found out that the disclosures are not as informative as supposed to be. 5 key points were identified as problematic. 1. Key assumptions of the management, 2. Sensitivity analysis, 3. Determination of recoverable amounts, 4. Determination of growth rates and 5. Disclosure of an average discount rate. As a result of the research has already announced as a part of the
European common enforcement priorities together with national authorities to improve the quality of goodwill impairment disclosures. (European Securities and Markets Authority, 2013)

The Finnish Financial Supervisory Authority follows in the same line in its report of 2011 and sent out enforcement letters to Finnish companies with in the top 5 enforcement letters included both, IFRS 3 for business combinations and second most of all enforcement letters was send regarding the IAS 36 standard. (Finnish Financial Supervisory Authority, 2011) Similar reports come from United Kingdom and Australia as well.

IFRS advisory bodies published a research made by Shinhan Financial group. In the research there was three different studies noted regarding the goodwill impairments. Kevin K. Li and Richard G. Sloan concluded that SFAS 142 leads to inflated goodwill balances and untimely impairments, the timing of impairments is wrong and managers use discretion granted by accounting standards to delay the goodwill impairments. The important notion is that this study was not performed for companies reporting under IFRS, but under US GAAP. However the goodwill impairment testing principles are not differing that much and same results would be reached under IFRS. (IFRS, 2012)

The 2nd study was performed by P. Van Hulzen, L. Alfonso, G. Georgakopoulos and I. Sotiropoulos. They concluded in their study that investors do not find it more useful to impair the goodwill compared to traditional amortization. The study indicated that investors do not find the impairment testing more useful in their valuation of share prices and therefore also not for decision making. (IFRS, 2012)

Third study, performed by D. Chambers, concluded that the annual impairment testing of goodwill increases the value relevance of financial reports for large firms experiencing financial difficulties, which is not relevant for smaller firms or more profitable firms. Chambers also concluded that elimination of systematic amortization reduced the quality of financial reporting. (IFRS, 2012)

2.7 Summary

This chapter has introduced and summarized the key concepts around mergers and acquisitions as well as goodwill impairments. The aim of the chapter is to give a good overall view for the reader regarding mergers and acquisitions as well as goodwill and its impairments as defined in IFRS accounting standards.

This chapter also gives a good overall view of the goodwill – from the reasons it arises on companies’ balance sheet to eventual impairment of it from the balance sheet. Certain theories have been introduced that are most vital to carry out the research. If some part of the theory was not considered to be relatable to this thesis it has been left out.

The key concepts developed in this chapter to help answer the research questions are provided. Firstly the chapter looked in to mergers and acquisitions and key theories behind them. Before the goodwill impairments are looked at in detail it is vital to understand different
forms of mergers and acquisitions as well as the underlying reasons why the companies are pursuing M&A strategies. As the main goal of the companies is to create shareholder value, it has been defined in this chapter. The abnormal equity returns are explained as a measure of shareholder value creation in an event window of M&A activity.

After the theories related to mergers and acquisitions the chapter moves on to define the goodwill. Short summaries of the international accounting standards board were introduced regarding the most important regulations related to accounting treatment of intangible assets and impairments. Goodwill impairment testing and its problems have been defined based on expert literature and recent studies regarding the goodwill impairment testing under IFRS.

While the theory behind M&A activities is pretty straight forward it poses a big underlying problem, especially related to the uglier reasons. It is very hard to prove if indeed there was empire building or management hubris involved in a business combination. On the other hand goodwill impairment itself serves as a proof of overpaying and shareholder value destructive behavior.

IFRS accounting standards provide a detailed set of rules and guidelines regarding the impairments, impairment testing and disclosures of the financial statements. However the guidelines are rather vague and leave a lot of room for management consideration. It is not clear overall how accurately and what kind of calculations should be disclosed to the financial statements. While the rules are technically clear, they leave too much room for interpretation.
3. Research methodology

3.1 Introduction

After defining the key concepts and theory behind the mergers and acquisitions as well as goodwill and goodwill impairments it is time to move on to the research methodology. The understanding of theoretical background behind the research is a key element to define the research methodology. Several limitations have been considered in order to select a suitable research methodology in order to provide detailed answers to the research questions.

This chapter kicks off with introducing the technical design of the research. After the research design has been discussed, data analysis and collection methods will be discussed in detail.

The research is a multi-method research consisting of 10 case studies for the companies that impairment could be linked to the acquisition and analysis of financial statements of 28 companies selected for the study based on impairments made in the companies. As the methodology is multi-method, the inductive method (for case studies) and the deductive method (for analysis of financial statements) will be used. For the first research question the method used is the quantitative method, to make generalizations regarding the IFRS financial statements and the qualitative method, for the 10 case studies included. The research strategy is a case study on case studies and archival research strategy for the financial statement analysis.

Data has been collected from Thomson one banker, SDC Platinuum through Thomson one. Also databases from Datastream and Reuters Fundamentals have been used. For the case studies newspaper articles have been read and analyzed. Research onion as well as conceptual design will be presented to help to visualize the nature of study. Finally an expert interview with a big four company auditing manager has been included to provide a closer link to the real business life.
3.2 Research methodology

3.2.1 A definition of mixed methods research

A mixed method research is an approach to inquiry that combines or associates both qualitative and quantitatives forms. It involves philosophical assumptions, the use of qualitative and quantitative approaches and the mixing of both approaches in a study. Thus it is more than simple collecting and analyzing both kinds of data: it also involves the use of both approaches in random so that the overall strength of study is greater than either one alone. (Saunders, 2009)
3.2.2 Philosophy

Philosophy adapted for this research is most closely related to ontology. Saunders defines ontology as concerning with the nature of reality. This raises questions about how the world works and the commitment held to particular views. More closely defined the philosophy is subjectivism. The subjectivist view is that social phenomena are created from the perceptions and consequent actions of social actors. (Saunders, 2009)

It is stressed that the necessity to study the details of the situation to understand the reality or perhaps a reality working behind them. This follows the view from interpretivism philosophy that it is necessary to explore the subjective meanings motivating the actions of social actors in order for the researcher to be able to understand these actions. (Saunders, 2009)

The research tries to find the quality of the information provided by financial statements and the underlying reasons why the information is provided as it is. For this research it is important to understand the motives of management to add noise to the financial statements or not to disclose the complete easily understandable information.

The research approach used for the thesis is deductive. For the first research question deductive methods has been used to form reliable generalizable data for the companies that showed goodwill impairments in their profit and loss statement for the research period. The group of case studied companies were derived from by the means of deduction from the first set of data by selecting companies which could be linked to certain M&A action taken earlier and that the merger or acquisition happened during the given time period. (Saunders, 2009)

3.2.3 Research strategy

The research strategy used for this thesis is also a multi-method due to the nature of the research. Firstly it will contain archival research. Archival research makes use of administrative records and documents as the principal source of data. An archival research strategy allows research questions which focus upon the past and changes over time to be answered, be they exploratory, descriptive or explanatory. However ability to answer such questions will inevitably be constrained by the nature of the administrative records and documents. Even where the records exist they may not contain the precise information needed to answer the research questions. (Saunders, 2009)

Another research strategy to complete the mix of methods used was multiple case study. Case study can be defined as a strategy for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context, using multiple sources of evidence. A case study strategy can also incorporate multiple cases, that is, more than one case. The rationale for using multiple cases focuses upon the need to establish whether the findings of the first case occur in other cases and, as a consequence, the need to generalize from these findings. (Saunders, 2009)
3.2.4 Time horizon

The research is defined as a longitudinal study, as it has to study change and development over time. The longitudinal research allows the researcher to study the changes over time and this is exactly what the study is about. It is looking for a time period of 7 years and development of eventual merger to following goodwill impairment.

3.2.5 Data collection and analysis

For the more practical approach of the research the data collection and analysis process that lead to the sample and data analysis will be discussed. The collection of the quantitative data was using the deductive method. (Saunders, 2009)

For this thesis mostly secondary data was used as the nature of the research was to study the financial statements and how the goodwill impairments are recorded in them. Also as a reference primary data was used by interviewing an audit manager in a big four company to provide a link between real business life and the secondary data. The secondary data used in this research included review of financial newspapers, several books derived from Rotterdam Business School library, data from Thomson one and Datastream, financial statements of the companies in study as well as several financial blogs and internet forums.

The research in nature is analyzing and collecting information of the companies so the primary data was not regarded as necessary to collect in regards of this thesis. The interview with an auditing manager of a big four company was performed to provide a link to a real business life. The interview is disclosed in the appendix and is the sole source of the primary data in this research. On the other hand it was considered to contact the companies of case studies in order to find their official view of goodwill impairments but the management positions for big companies are very hard to reach and in most of the companies given the time period of research these people are not even working in those companies anymore.

The data collected was consisting mainly of financial statements of the companies in order to study the notes of the financial statements. Also the data was collected from Thomson one Banker to get the key ratios for the companies as well as financial statements in digital and editable form.
3.2.6 Sample selection

The research was carried by using the Thomson one banker database in Erasmus University Library. The parameters entered were to show publicly quoted companies from Finland that had recorded goodwill impairments in their financial statements for the years 2004-2012 and reported under IFRS. This search provided 51 companies. Further analysis was made and the sample size was deducted to 28 companies. The deduction was made based on the impairment of goodwill – that there was an actual goodwill impairment based on impairment testing. The 22 companies excluded had recorded goodwill impairments for discontinuing operations or the sale of the part of the company.

Furthermore 10 companies were picked to the case studies, based on the information provided on their financial statements and that the impairment charge could be linked reliably to the preceding acquisition.

For the 10 analyzed companies further details about their stock performance was derived from the Thomson one banker data base that records the movements of the stocks and provides historical data. The index used to derive the abnormal equity returns was OMX Helsinki PI, which includes all the companies listed in OMX Helsinki. No beta was taken into consideration as the purpose was to deem the merger or acquisition as a success or failure.

Private acquirers were not considered as getting the financial statement data could not have been possible.

3.2.7 Delimitations

There were several major issues with this research topic. Majorly lack of acquisitions in Finland for the considered time period as well as small number of impairments made related to acquisitions in the 6th wave of mergers and acquisitions. Also the data required was only accessible with Erasmus University databases which are very expensive to purchase. Thus most of the research was limited to the opening hours of information desk in Erasmus University Library. Also the original research plan of linking the merger and acquisition to a goodwill impairment proved to be impossible approach as there was no possibility to link reliably certain merger and acquisition to the subsequent impairment of the goodwill. What was proven to be very challenging was to find the set of companies that were involved in M&A activities and impaired goodwill. As in IFRS it is not allowed to amortize goodwill, it gives very little incentive to management to impair the goodwill even if the M&A is failing to provide shareholder value.
3.2.8 Reliability and validity

The single most important factor for any research is validity and reliability. Reliability refers to the extent to which research data collection techniques and analysis procedures will yield consistent findings. It can be assessed by posing the following questions:

1. Will the measures yield the same results on other occasions?
2. Will similar observations be reached by other observers?
3. Is there transparency in how sense was made from the raw data?

In researcher point of view the reliability condition is being met. The measures would yield the same results on other occasions, based that the data was taken from 28 financial statements all of them provided the similar data. Also similar observations would be reached by other observers. Finally there is transparency in how the sense was made, which will be discussed in the findings chapter. (Saunders, 2009)

Validity conditions are met by research methods as well. In many cases it was detected that the data from Thomson on Banker differs from the financial statements of the company substantially. As a result all numbers reported in findings are based on financial statements of the companies as well as key ratios are derived from the financial statements instead of Thomson one to ensure the validity of the data.

3.3 Summary

This chapter aimed to provide the reader a good idea what the research is about, what research methods have been used and which other things were considered during the research design. The nature of the study is very complex and mixed methods approach was selected to carry the research. The thesis aims to be as valid and reliable as possible. Certain delimitations such as availability of information have been discussed in this chapter.

The previous chapters have been used as a key reference to define the correct research methodology. As the research is looking into the financial statement information as well as to provide a link between the merger and acquisition reason and initial stock market reaction it has been divided to two different types of studies, hence a multi-method research has been applied.

The delimitations have been considered briefly in this chapter to provide better overview why the research method was chosen and applied and will be discussed further on in the following chapters.

After developing a good understanding about the research methods used and delimitations considered we can move on to findings, which will provide the information about the study as well as general condition of Finnish financial statements as well as to shed some light to goodwill impairments that happened in Finland between 2007 to 2012.
4. Findings

4.1 Introduction

In this chapter the findings of the research will be introduced. The chapter starts with introducing the data about the financial statements and summarizes what has been found when studying the financial statements of the company in detail. For all the 28 sample companies the financial statements were easily available. The research shows that data disclosed in the notes for the financial statements is inconclusive and does not provide the reader of the financial statements the information necessary to make solid conclusions about impairments. Also the financial statements, especially the main accounting principles, are very general and almost identical for all the companies regarding goodwill impairments.

The second part of this chapter consists of 10 case studies where certain variables have been used to determine if the link can be created to the failure reason of M&A. The research proves that no such connection can be made based on the numbers and impairment of goodwill is being made regardless of initial stock market reaction towards M&A activity. It seems evident that the other motives play bigger part in the goodwill impairment.

Also an interview with a big four auditing manager was performed as part of the research. The main findings of the interview will be considered here as part of the findings.

Finally the findings will be summarized in order to provide the reader a clear view of the findings of this research. All the case studies and the data of the financial statement analysis are provided in appendix 1 and 3 and the interview transcript is disclosed in appendix 4.

4.2 Financial statements

For the purpose to form a sample big enough 28 companies that had recorded goodwill impairments were analyzed to come up with a conclusion. The quality of statements and information provided from the company varies notably. The major parts considered here were derived from IFRS disclosure requirements and then the most significant goodwill impairments were selected for further analysis. The focus was set on to most important elements in the financial statements regarding goodwill impairments. These were key assumptions to for future, allocation of goodwill to cash generating units, forecast period for value in use calculations, assumptions and basis for valuation, sensitivity analysis and reason for impairment. All of the 28 companies analyzed used value in use method to perform the goodwill impairment test. Financial statements were the biggest source of the information, as the disclosure requirements provided in appendix 2 require the companies to report in their notes of the financial statements.
The researcher has selected the most important topics to discuss in this chapter that are required by IFRS disclosure regulations. The full list of requirements can be found from Appendix 2, but the ones selected to be discussed in this chapter are the ones that provide the most informational value to the reader of the financial statements and thus discussed more in detail.

The companies were selected based on that they had goodwill impairment loss on their financial statements and which was not constituted of sale of some part of business or discontinued operations. Data tables which were used for the analysis are disclosed in appendix 1.

As per auditing point of view, it is important to keep in mind that not all the disclosure deficiencies are related to management willingly adding noise to the statements. It can be partly the unclear or too general set of requirements for the disclosures by accounting standards as well as how big the impairment is. In case of a small impairment that has very little effect on the profit and loss statement, the disclosures are not in that high importance either. The underlying question is, how much does do the disclosures affect the perception of the reader. In case insignificant impairments might not be disclosed as well as more significant ones.

The main point that was found out during the interview with Mr. Bellekom was that the companies are according to his point of view trying to comply with the requirements of the IASB as much as possible. However there is lot of points where the instructions are not clear enough. Also from auditing point of view it is relevant if the disclosure changes the perception of the reader. While the standards do not provide clear guidelines and leaves a lot of consideration for management to decide how to close the required facts, it remains unclear for how long the companies can continue disclosing the less transparent and less comparable data.

4.2.1 Key assumptions for future

As we can see from the data disclosed in appendix 1, most of the companies assumed future to be challenging due to economic downturn. Only 2 out of 28 companies stated that economic downturn will have no effect on their future. However the remaining 26 companies also had expectations of revenue either to grow or stay stable for the forecast period. This was most commonly based on long term growth expectations. According to IFRS companies are required to disclose key assumptions for the future. Many of the companies’ assumptions were overly positive considering the economic downturn at the time. Also no hard figures were closed and the key assumptions were based on budgeted forecast of revenue and operating profit, which is not public information and thus makes it very hard for reader of the statement to understand what the real reason behind the goodwill impairment was. According to the interview, these are highly subjective assumptions. Usually management is overly positive about the future and this reflects to the disclosures and assumptions for future.
4.2.2 Allocation to cash generating units

IFRS accounting standards require companies to disclose the allocation to cash generating units where the goodwill has been allocated to. The most common ways is to allocate the goodwill to geographical segment or business segment (or combination of these two). Only two of the companies failed to disclose the cash generating units that goodwill was allocated to or the allocation was unclear. What is notable with the allocation to cash generating units is that many of the companies use very huge cash generating units. (ie. Europe, North-America, etc.). This makes it very challenging for reader to understand what part of the business is not generating the expected returns. Also definition of cash generating unit is that, it is supposed to be smallest possible unit that generates independent cash flows. It is hard to believe that many companies have only one cash generating unit per country or per business line. Based on the interview allocation to cash generating units is done as accurately as possible. However in case of goodwill this is very challenging to estimate where the expected synergies will form the cash flows. Many of the business combinations aim for decreased level of costs and that does not generate cash flows per se.

4.2.3 Discount rate

The pre-tax discount rate averaged 10.9% for all the companies analyzed. This seems very low considering that lot of the M&A activity was towards Baltia and Russia being big growth markets with higher risks involved as well. Also there was no clear and reliable connection to be made with the business line and discount rate. Some of the companies in IT business reported substantially varying discount rates. (Affecto 17.3% and Ixonos 12.7%). The discount rate should also reflect the riskiness of the asset under consideration. However this was not evident from the findings and the discount rates used are highly subjective to the management opinion about expected risk associated with the assets under consideration. This can be a positive sign as well, seeing that companies actually use discount rates with higher associated risk when doing goodwill impairments instead of their pretax weighted average cost of capital. However as the details of discount rate is not disclosed it is very hard to assess the truthfulness of the correct rates used in impairment testing. As the cash flows are not required in disclosures the discount rate is the other variable that effects the DFC calculation and thus was analyzed for the purpose of research.

4.2.4 Forecast period

Forecast period derived from two to ten years and three companies did not disclose it all. Most commonly used was five year forecast period. However notable here was that there was
no reason given why the selected forecast period has been chosen. This is completely in line of the IFRS regulations of using the latest forecasts for maximum of five years ahead.

4.2.5 Assumptions for forecast

The assumptions for forecast were not disclosed for 11 out of 28 companies involved. However the remaining companies disclosed the assumptions – most commonly used was the revenue growth resulting cash flows for the forecast period and after the forecast period 2-3% growth. This does not increase the understandability or the transparency of the statements. Depending what assumption was used regarding the terminal amount of cash flows past the forecast period can differ hugely between companies. When the information is not provided it raises a question about reliability and validity of impairment testing. As per interview with Mr. Bellekom, it was noted that the biggest possible impact on differences of DFC calculations come from the terminal period and assumptions used for that. These varied highly with the disclosures from being not disclosed to 0% growth to the top of the line by Digia PLC which used 3% revenue increase and 10% operating profit increase to derive the cash flows. This naturally has huge impact on the expected cash flows and thus to the usefulness of impairment testing.

4.2.6 Sensitivity analysis

Another essential part for readers of financial statements is the sensitivity analysis. In short it tells how likely the future goodwill impairments are and what kind of change in the cash flows or discount rate will result in further impairments of goodwill. 16 out of 29 companies either did not disclose the sensitivity analysis or it was very unclear what would result further impairment. Mr. Bellekom during an interview said that it would be best if the companies would disclose the sensitivity analysis in form of table, showing the effect of changes in accounting estimates. Ie. what would happen to the capitalized goodwill if the discount rate changed 1% or the estimates of future growth would be 1% lower. Too little companies disclose this information in a transparent and standardized format, making it very hard to assess to impacts of future developments in the amounts of goodwill capitalized.

4.3 Case Studies and goodwill impairment analysis

The extensive analysis was made for the purpose of the research regarding the goodwill impairments of 28 publicly quoted Finnish companies. The total amount of goodwill impaired was 640 Mill EUR. This constituted 1.24% of total assets of the companies analyzed and 17.77% of total goodwill reported in the balance sheets. For the purposes of this thesis 10
companies were selected for case studies. The companies were selected based on linking the goodwill impairment to the earlier merger and acquisition. The companies were selected based on where such link could be made reliably. The stock market reaction was deemed as a success or a failure based on abnormal equity returns in a seven day event window around the acquisition date. This provides accurate information regarding how stock market saw the acquisition announcement. It turned out that the stock market reaction to the M&A activity was erratic in nature. Only four of the acquiring companies analyzed reported negative abnormal equity returns on a seven day event window. The average abnormal equity returns were 2.5% positive and average time between merger and acquisition and following goodwill impairment was 2.5 years. This shows that there was no link between the expected failure or success of the M&A activity by stock market reaction and following goodwill impairments. It is possible that the economic downturn that started in 2008 and lasted thru the whole research period played a big part in the results. However there is no data available for the time period long enough to compare the results to the peer group and what would happen if the banking crisis didn’t happen.

4.3.1 Data

The data collected for the analysis is summarized and shown in the appendix 1. All the data is collected from financial statements of the companies.

In addition there were 10 case studies performed to get more detailed view of the goodwill impairments and to come up with a reason for goodwill impairment. The case studies were performed and analyzed based on the financial statement information of the companies in the year of impairment. Also taken into account was the financial press reaction to the M&A announcement. The data was easily available and accessible. The analysis to the financial press, stock market reaction and reason for the merger and acquisition could not be linked reliably to each other.

To understand the defining factors behind goodwill impairments the companies’ revenue, operating profit or loss, Price to book ratio and goodwill to total assets were analyzed. The data was taken from the financial statements of the companies as the data from Thomson one Banker database seemed to differ from the reporting in most of the cases.

The data collected shows that the operating profit companies decreased in the year of goodwill impairment on average -200%. The deviation of the data was very high, low being -560% and high 14% increase. As the data deviates so much no regressive analysis was made based on this. However what is evident is that in the year of goodwill impairment the companies were making already exceptionally low profits.

The interview with Mr. Bellekom provided a good insight in the way companies are performing their goodwill impairments. According to him the lot of goodwill impairments is a result of over positive assessment of the forecasted synergies by the acquiring management. It can be related to management hubris theory, but in practice it is very difficult, if not impossible to draw the line between the healthy confidence of management and belief in their strategies to actually go that far to say that management is diligently pursuing shareholder value destructive
activities. The researcher firmly believes that management needs to believe in what they are doing or the actions they take are doomed to be value destructive. To deem the M&A action to be result of the empire building is equally hard. It would require in depth industry analysis as well as company analysis to derive such a conclusion. Other companies are in more mature phase of the business and may need to decide between no growth and growth thru business combination. These factors cannot be derived from the financial statements of the companies.

Also what was found out in the interview was that companies are aiming for bigger one time impairment, instead of doing several small ones. This indicates more towards the earnings management on some level. It is more favorable for management to impair the goodwill during either a one bad year or on a year that earnings targets has been already met. Given the disclosure deficiencies apparent in almost all cases it leaves way too much freedom for management to follow their incentives.

While there was no connection made between the stock market reaction and uglier reasons for M&A strategies, it seemed to be more evident that companies are impairing heavily their assets during the bad years of business. This is not limited only to goodwill, but also other assets that are subjected to impairment test.

Data tables and detailed analysis can be found in the appendices 1 and 3.

4.4 Summary

In this research there were a total of 28 financial statements analyzed to find out the quality and informational value of disclosures of financial statements. 10 of these 28 companies where the M&A activity could be linked to an earlier merger and acquisition was further analyzed to find out the link between stock market reaction and the consequent goodwill impairment.

The data collected and analyzed for the research was highly variable and no regressive analysis could be performed based on the data. This constituted from several facts: lack of goodwill impairments and mergers and acquisitions in Finland, different nature of the companies analyzed and different sizes of a company. Also the goodwill impairments relate highly to the geographical location of cash generating unit and country risk associated with the area. Thus it was decided to use more qualitative analysis as the usefulness of quantitative data of this research is highly debatable. The bigger companies have huge impact on the amounts of total goodwill in balance as well as total amount of goodwill impaired. Also different industries have different markets and risk factors, and with this small sample data dominant industries have high impact on the data.

Eventually the data provided in financial statements of the companies is highly variable and the informational value is lacking. Companies seem to interpreted the rules differently and disclose the impairments and impairment effects as per literal meaning of the IFRS standards and the nature of the standards. Also reliable link between the M&A activity, stock market reaction and following goodwill impairment could not be made. Stock market reaction seemed to provide no connection to the eventual impairment at all.
This does not necessarily mean that all the companies are following earnings management schemes in their accounting. Interviews with an auditor proved that according to his experience it is hard to say if it is apparent and done on purpose or is it actually done bona fide. It can be concluded that management of companies is overly positive about their own M&A activities. However this is very hard to prove and to link it to the Hubris theory reliably enough to draw conclusions.
5. Discussions

5.1 Introduction

In this chapter the researcher will link the findings to the theoretical background introduced in literature overview as well as defining how the research answers to the research questions. The data analyzed provides the answers for the research questions. To understand the goodwill impairments it is very important to understand first the reasons that lead to the recording of goodwill in the balance sheets of the companies.

The first question was answered by studying the financial statements of 28 sample companies that recorded goodwill impairments in their financial statements. It can be concluded that even with the same set of rules the information provided varies a lot. While the IFRS disclosures are clear on what needs to be disclosed, the lack to meet these requirements is evident. It became conclusive that the IFRS standards and disclosures have not improved the usefulness of financial statements to their readers due to noise added to statements as well as failure of companies to disclose the most vital data regarding the goodwill impairments.

The connection between stock market reaction and goodwill impairment was not evident; in fact in the sample of acquiring companies the initial stock market reaction provided very little information regarding the following goodwill impairments. Thus there is no connection between initial stock market reaction and consequent goodwill impairment. Also what needs to be kept in mind was that the banking crisis of 2008 might play a big part in this puzzle as well resulting unexpected impairments. However it seems suspicious that the companies quote “long term industry growth averages” in their key assumptions for goodwill impairments. It would be more conclusive if the expectations of market decline would be quoted while impairing goodwill, but this was not evident from the financial statements of the companies.

5.2 Financial statements

IFRS reporting standards, IAS 36 and IAS 38 provide clear guidelines about the disclosures to the financial statements. The aim of these standards is to improve comparability and transparency of financial statements in the countries that have adopted IFRS.

The detailed study to the financial statements of sample companies seems to contradict with the purpose of IFRS. Even though the key accounting principles quoted in the notes to the financial statements are almost word to word within all the companies the actual disclosures are light years apart from each other. Key interests for the reader of the analysis are the assumptions for future, discount rate used, assumptions made for forecasting as well as sensitivity analysis. Also carrying amounts of goodwill and changes to goodwill are important,
but these are already disclosed in the balance sheet and income statements for a knowledgeable reader.

The research showed that IFRS has failed to increase the transparency and comparability of goodwill impairments in the financial statements. In the research there was no company that fully complied with the nature of IFRS disclosures. This was especially true considering future assumptions which were very generic and provided very little information. In the statements it was mainly quoted as “the management expects the future remain challenging due to economic down turn, but with cost savings and growth of particular market the company expects steady long term growth”. Also management approved growth expectations/budgets were used as a reference. This is no public information however and it is for a reader very hard to assess what does that really mean and if they are on a realistic level.

Also notable was lack of sensibility analysis in almost half of the companies. It is very important for reader who is interested in future of the company to know what kind of impact future would have on the goodwill balance and especially for decreasing the profits available for the shareholders on the year of impairment. The basis for value in use calculation was not disclosed clearly enough. In most cases the valuation of terminal period was not disclosed. As this have huge impact on expected cash flows it would help very much if the assumptions for this would be disclosed. Also the basis for cash flow assumptions was not disclosed clearly, generating even more questions about the management honesty in goodwill impairment testing.

All things considered the goodwill impairment disclosures are not on a level that it would make it easy for reader to understand why the goodwill impairment was done, what was taken in to account while testing and more over what are the future impacts of the goodwill testing. Until these key assumptions are clearly closed the goodwill impairment explanations in the notes of the financial statements remain unclear and incomparable.

On a positive note there has been clearly improvement in the notes of the financial statement and trend was visible towards the better reporting in the future. Much of it concludes to the fact that goodwill impairment is very new factor in most of the countries and the researcher believes that very few readers of the financial statements pay much attention to the goodwill impairment and impairment testing. However this could have huge impacts on the companies’ income statement for companies that record high amounts of goodwill in their balance sheets.

5.3 Case studies

The purpose of the case studies was to provide the answer for the second research question: The connection between stock market reaction and following goodwill impairments. For the case studies 10 companies were analyzed in detail. The companies selected all reported goodwill impairments in the years 2007-2012. Thus it can be concluded that the M&A activity related to that goodwill impairment failed to generate expected shareholder value. As goodwill is the indication of expected values from synergies the impairment of goodwill signals already that the M&A activity failed to provide expected return.
The study showed absolutely no connection between stock market reaction and deeming the M&A activity success or failure and the subsequent goodwill impairment. (table 2.) Quite the opposite, 60% of analyzed companies were greeted with positive abnormal returns in a 7 day event window. The study of the newspapers or financial statements did not provide any linkage between the reason behind the M&A and the subsequent goodwill impairment.

It is evident that the stock market reaction cannot be used as a signaling factor for future impairments. It is more related to the believability of management and if the stock market buys the valuation of business combination provided by management.

During the research it was discovered that the companies are likely to do goodwill impairment on a year that is going to provide decreased profitability and/or revenue. Nine out of ten companies made the goodwill impairment in a year that profitability and revenue were decreasing compared to previous year. During these years no single goodwill impairment could be traced as a sole reason of declining profitability. Analyses were made based on adding the impairment back to the profit and loss statement and no case showed that a goodwill impairment solely constituted the declining profitability. However during these years impairment charges of other assets as well were higher. This suggests that the big bath theory is evidently presented in the cases studied. That is the only common nominator found in the cases studied.

What was also found out was that goodwill impairment did not play a significant factor in the net profit for that year. However impairment charges were constantly high during the years of goodwill impairment, signaling that all long lived assets were depreciated and impaired during the same year. It takes a lot of time to study this from the statements and the financial media. It was surprising to find out that these evidence and connections were not more largely studied before. Also what can be linked to all of the companies is empire building and management hubris. All of the companies overpaid in their M&A activity and thus needed to make goodwill impairments. However this connection is not evidential and there are several other reasons that were effecting the goodwill impairment. The general economic downturn probably paid big part of the impairments, but this was in contradiction to what companies reported about their future prospects and key assumptions for goodwill impairment testing.

5.4 Summary

The executed research project was sufficient to answer the set up research questions. However the results were surprising and unexpected. The companies (with or without purpose) seem to leave the vital information undisclosed regarding the goodwill impairments. The quality of the statements varies significantly from company to another.

It was evident that even the big list of disclosure requirements by IASB is not sufficient enough and leaves way too much for management consideration regarding the disclosures of goodwill impairments. Lack of sensitivity analysis and key assumptions regarding the DFC calculation were the most notable thing, making it very hard for a reader to assess the future impacts and possible goodwill impairments.
Regarding the case studies no correlation between stock market and press reaction to the original M&A activity and following goodwill impairment was found. The case studies suggest that companies are using the big bath earnings management scheme to take all the losses in one year to increase the chances of higher profitability in the future rather than impairing purely based on fair value of the goodwill. It was noted that bad years might have impact on goodwill impairments in form of decreased cash flows in a cash generating unit. However most of the companies did not disclose this as a reason for goodwill impairment. The companies seemed to be positive about the future developments in the cash generating units that goodwill impairment took place.

The linkage between M&A failure reason and the subsequent goodwill impairment could not be made. This is due to several factors, but most importantly because it is very hard to prove reliably that there was an uglier reason behind the business combination. According to interview with Mr. Bellekom, it is the overly positive attitude towards the business combination that causes the overpayments and subsequent goodwill impairments. It is almost impossible to draw a line between confidence and overconfidence to managements’ own abilities.

6. Conclusions and Recommendations

6.1 Introduction

In this chapter the conclusions are made from the research. The chapter starts with the conclusions of the work and then moves on to the limitations of the research. It can be concluded that the IFRS 3 business combinations and IAS 36 and IAS 38 have failed to improve the usefulness of the financial statements. The quality and informational value of the statements have not increased notably as a result of IFRS regarding the goodwill impairment accounting. The main factor behind this is interpretation of the standards as well as management added noise to the statements.

For the 2nd research questions the link between stock market reaction and failure reason derived from literature could not be made. This is due to several external factors such as availability of the data and lack of an evitable link between the failure reason and consequent goodwill impairment. Also the sample group represents a small number of companies and the companies operating in different market segments.

There were also several limitations to the research such as the nature of Finnish financial media, the availability of reliable data regarding the empire building and hubris theory and to prove those, very detailed analysis would need to be performed, including interviews of the company management as well as detailed knowledge of the markets companies operate in.

6.2 Conclusions
6.2.1 Financial statements

The financial statements of the companies proved to vary a lot. It seemed almost like companies reported what they wanted to show to the reader of the statements. Lot of vital information was missing, especially in the companies that showed high amounts of goodwill in their statements compared to total assets. For those, the lack of sensitivity analysis was outstanding. This is the most vital information especially for investors, who are more interested about the possibility of further goodwill impairments and their effect on future profitability of the company.

While the IAS 36 and IAS 38 are followed in a technical point of view, the nature of the disclosures is not followed as intended in IFRS accounting standards. From purely technical perspective the companies researched are following the disclosures. However the scope of these disclosures is to create more transparency and comparability to the financial statements and this is not achieved.

As a conclusion the IAS 36 and IAS 38 in combination with IFRS 3 have failed to create the standardized and transparent financial reporting standards. It is partly due to the fact that goodwill impairments and impairment testing is not fully disclosed and there is way too much room for management consideration in the assumptions. The expected growth is purely an internal factor based on assumptions as well as the terminating value and expected growth for the terminating value, which can impact hugely the value of expected cash inflows. Also the companies are not required to report expected growth per CGU, which makes it almost impossible to assess the possibility of future goodwill impairments. IFRS requires the reporting to be per segments, but it is not required that segments and CGU’s would be the same.

As a conclusion we can say that the informational value of goodwill impairments is very low for the readers of financial statements. The companies are not complying to the IFRS standards with the nature or purpose of the standards. It is evident that IFRS has not succeeded in creating more transparent and comparable financial statements.

6.2.2 Case Studies

With the case studies performed it can be concluded that there was no evidence found that stock markets could accurately predict the failure or success of the M&A at the moment of announcement. The only common nominator in the case studies that was found regarding the goodwill impairments was that 90% of the goodwill impairments were done on an exceptionally bad year. This can be partly explained by the high amount of impairments in 2009, when the OMX Helsinki hit rock bottom. However the companies did not indicate this downturn to have effect on their future prospects and quoted “expected long term growth rates” as a base for impairment testing. Also future prospects were in all cases positive and none of the companies
admitted, based on financial statements and newspapers, that the times will be unprofitable for them in the future.

This research indicates that the thriving factor behind the goodwill impairments may be the big bath accounting and earnings management. Companies are willing to take a bigger dip on already what is considered a bad year in order to be more profitable in future years. This was true in nine of the researched ten companies. However it is also good keep in mind that the goodwill impairment is more or less considered a one-time charge rather than actual impairment testing based on fair value and done yearly. It is hard to explain why the companies that were impairing during the 2009 were not impairing during 2010-2012 when the economic growth showed very few signs of recovery.

While the linking to the failure reason of M&A was not possible, it is still very important to understand the factors that are behind the capitalization of goodwill to the balance sheet. Also understanding the reasons behind the business combinations sets a concrete base for understanding the nature of goodwill as well as the consequent impairments.

As a conclusion it can be said that stock market cannot predict accurately the success or failure of business combination. It relates more to how much of the managements reasoning they buy at the moment of M&A announcement. The data varies a lot and as concluded earlier the goodwill impairments are done seemingly based more on management consideration than real life events.

6.2.3 Limitations to the research

There were several limitations to the research and in this part those will be summarized. Firstly the companies recording goodwill impairments were rather hard to find. What made it hard was the differentiation of reasons for goodwill impairments. As the impairments for discontinued operations and sale of assets were not considered every statement needed to be hand-picked and further analyzed what the goodwill impairment was based on.

The second limitation was the validity of Thomson one banker data. It differed in several cases from the data in financial statements. Thus for the analysis financial statement data was used and/or verified from the statements. This made it very time consuming to go through all the statements.

Thirdly the nature of Finnish media is very objective. It is hard to find implications for empire building and hubris based on the newspapers. They tend to report the happening without inserting subjective views in to it. However several financial forums and blogs were read where these implications were made. These were not considered as reliable and valid as this data could not have been verified reliably.

Also the research questions and objective needed to be changed as the data was not available for the original idea of linking M&A activities to failure reasons. There was just not enough M&A activity in the Finnish market and the companies that were acquired or merged did
not perform goodwill impairments in the subsequent years, except for the ten companies picked for case studies. The linkage between failure reasons and goodwill impairments could not have been made based on available information and there was not enough evidence that the link could have been formed reliably.

6.3 Recommendations

The recommendation chapter is divided into the three separate parts. The first part is the recommendations to the International Accounting Standards Board. The second part is recommendations to the auditors and finally the third part looks more into the perspective of the readers of financial statements and investors.

6.3.1 Recommendations to IASB

The recommendations of the researcher to the International Accounting Standards Board are in line with the recommendations of ESMA (European Securities and Market Authority). Regarding the financial statements it is important to improve the quality of the disclosures in financial statements.

Firstly, it would be needed to look into the disclosure requirement (in appendix 2) and clarify the instructions. At the moment there is way too much room for interpretation of the rules. ESMA calls for the following improvements:

- Better specify the key assumptions used in the impairment test
- Include sensitivity analyses with sufficient detail and transparency, especially in situations when indicators are present that impairment might have occurred;
- Determine the growth rates used to extrapolate cash flows projections based on budgets and forecasts; and
- Disclose specific discount rates for each material cash-generating unit rather than average discount rates.
- Improving the rigor applied by issuers in the impairment test of goodwill;

Monitoring the application and compliance with IAS 36 requirements on goodwill impairment, in particular with regard to:
Reasonableness of cash flows forecasts;
Key assumptions used in the impairment test;
Sensitivity analyses provided

(European Securities and Markets Authority, 2013)

All of the above mentioned things are very important for the readers of the financial statements. The researcher also would like to add to the list couple more points:

- The assumptions regarding the termination period if value in use or in other words DFC calculation has been used
- The disclosures about the original business combination that capitalized goodwill originates from
- Clarification of determining cash generating units as now the companies has too much freedom to allocate the goodwill – now goodwill can be reassigned to cash generating units in case company decides to change their cash generating units.
- Standardized format for disclosures of goodwill impairments

With the research it is conclusive that this recommendation by ESMA needs to be met in order to provide readers of financial statements more transparency and comparability. Also additional information never hurts when reading the financial statements and the information the researcher recommends to be added should be considered as well.

6.3.2 Recommendations to Auditors

The recommendations for auditors would be to challenge the management view as much as possible. From the researcher point of view and the interview with the auditor they are doing as good job as possible. As the auditing manager mentioned several times, there is no way to predict the future accurately and if the management has good reasoning for their forecast it is impossible for auditor to challenge them.

The researcher recommends the auditing firms to come up with a standardized process for the auditing of goodwill impairments. One solution could be to collect the data about the future prospects of the industry and if the key assumptions derive from the industry standards notably then further investigations would be conducted. However in practice this would be very cumbersome process and especially in the case of goodwill, which does not generate cash flows alone very hard to implement. This would as well go against the main target of IFRS accounting rules, which aims to be more principle than rule based.

Auditors should however ensure and enforce that the IFRS disclosure requirements are followed and all the necessary information is disclosed in the financial statements of the companies to higher extend.
6.3.3 Recommendations to the investors

The researcher recommends the readers of financial statements to pay extra attention to any company that records vast amounts of goodwill in their balance sheet. The investor should be extra careful when the company’s balance consist over 20% of goodwill. For the companies recording more than 50% of the total assets in goodwill should be regarded as a very risky investment decision.

The goodwill is very sensitive asset, given that it consists only of future synergies and as discussed, the future is impossible to predict accurately. Moreover the goodwill represents the overpayment in the acquisition over the assets and liabilities that can be recognized to balance sheet on their fair value. This makes it particularly risky asset, which should be taken in to account in the valuation of the company. As derived from the literature 60-90% (depending on source) of M&A activities fail to generate the expected shareholder value. This in turn should translate to the fact that 60-90% of companies with goodwill recorded in their balance sheet will eventually need to impair their goodwill pushing the earnings down during the years to come.

This should be taken in to consideration when assessing the future value of the company, especially in the cases where the company has not showed any goodwill impairments in the long run. Moreover the capitalization of goodwill to balance sheets inflates the balance sheets notably. In general it is impossible to derive any certain set of rules that could be derived from the financial statements of the company to assess the possibility of the future impairment. There are indicators, such as low book to market value that makes the future impairments more probable. However the industry knowledge and recasting the financial statements would be necessary to assess the effects of goodwill properly.

6.3.4 Final word

As a conclusion at the moment there is too much noise and differing ways of disclosing the financial statements and very detailed analysis needs to be performed in order to even find out how likely the future impairment will be and in many cases studied this was not possible to make any kind of assessment about future impairments.

Regarding the stock market reaction and deriving the possibility of goodwill impairment based on if the markets define M&A activity as failure or success no connection could be made. Only recommendation that researched is willing to make is not to follow the general consensus of stock market when deeming the business combination success or failure.

Auditing of goodwill impairments is another hot topic in the field of goodwill research at the moment. The interview with the auditor for this thesis, underlined the impossibility of predicting the future accurately. Also it is very difficult for auditors to challenge the management view of the future. Peer comparison and general consensus about the future market movements can be
used, but finding an exact peer (not to mention that their view of the future would be more correct) is very hard.

As far as IFRS remains as a more principle based set of accounting rules and standards it is unlikely that informative value of disclosures will increase. In comparison to more rule based local GAAP’s and main competitor US GAAP stay more focused on following stricter set of rules it remains highly inconclusive if the IFRS based goodwill impairment and impairment testing will ever provide more transparent and standardized view for the financial statements.
Bibliography


HelsinginSanomat. (2005). *HelsinginSanomat.* Noudettu osoitteenä Kemira Group to purchase Finnish chemicals and Dutch Specialty chemicals company Verdgugt:


Appendix

Appendix 1. Tables

Table 1 Financial statements
<table>
<thead>
<tr>
<th>Company</th>
<th>Key assumptions for future</th>
<th>Allocation to CGU’s</th>
<th>Discount rate</th>
<th>Forecast period</th>
<th>Assumptions for forecast</th>
<th>Sensitivity analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Afarak Group OYJ</td>
<td>Synergies thru distribution network, customers, skilled management</td>
<td>Based on geographical location</td>
<td>Not disclosed</td>
<td>5 years</td>
<td>5 year forecast 0% growth after 5 years</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Affecto OYJ</td>
<td>New business strategy of streamlining IT service business in Baltic</td>
<td>Based on geographical location</td>
<td>17.3%</td>
<td>5 years</td>
<td>5 year forecast 2-3% growth after 5 years</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Aspocomp Group OYJ</td>
<td>Long term returns on the business line</td>
<td>Based on business line</td>
<td>11.2%</td>
<td>5 years</td>
<td>5 year forecast 3% growth after 5 years</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Atria OYJ</td>
<td>Times will remain challenging due to economic downturn</td>
<td>Based on geographical location</td>
<td>7.5%</td>
<td>5 years</td>
<td>Revenue forecast to 1% growth rate</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Biohit OYJ</td>
<td>The CGU (which is not disclosed in detail) will start making profits in the future</td>
<td>Not disclosed</td>
<td>15.0%</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Capman OYJ</td>
<td>The future is slowed down by the economic downturn</td>
<td>Based on geographical location</td>
<td>12.3%</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Cramo OYJ</td>
<td>Financial crisis, major slowdown in the market</td>
<td>Based on geographical location</td>
<td>10.1%</td>
<td>5 years</td>
<td>1.7-19.9% Sales growth for forecast period, after 2-3%</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Digia PLC</td>
<td>Economic downturn, mobile business specially risky</td>
<td>Based on business line</td>
<td>14.7%</td>
<td>5 years</td>
<td>8-9% profit increase yearly</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Finnair OYJ</td>
<td>Economic downturn, sales decreasing</td>
<td>Business segments</td>
<td>10.0%</td>
<td>3 years</td>
<td>2% annually</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Finnlines OYJ</td>
<td>Economic downturn, sales decreasing, restructuring</td>
<td>Combination of business segments and geographical location</td>
<td>6.7%</td>
<td>3 years</td>
<td>2% yearly increase in sales</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Glaston OYJ</td>
<td>Economic uncertainty, tough competition</td>
<td>Business segments</td>
<td>16.5%</td>
<td>5 years</td>
<td>20% yearly increase in sales</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Huhtamaki OYJ</td>
<td>Restructuring will decrease short term cash flow expectations</td>
<td>Business segments</td>
<td>14.7%</td>
<td>5 years</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Iconos OYJ</td>
<td>Smart phone markets increasing great prospects for the future</td>
<td>Business segments</td>
<td>12.7%</td>
<td>4 years</td>
<td>Revenue growth 4% forecast period 1% after that</td>
<td>Disclosure unclear</td>
</tr>
<tr>
<td>Kemira OYJ</td>
<td>Economic uncertainty, tough competition</td>
<td>Business segments</td>
<td>8.6%</td>
<td>5 years</td>
<td>Not disclosed</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Company</td>
<td>Key assumptions for future</td>
<td>Allocation to CGU’s</td>
<td>Discount rate</td>
<td>Forecast period</td>
<td>Assumptions for forecast</td>
<td>Sensitivity analysis</td>
</tr>
<tr>
<td>-------------------------</td>
<td>-------------------------------------------------------------------------------------------</td>
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<td>-----------------</td>
<td>-------------------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>Kesko OYJ</td>
<td>Economic deterioration, customer benefit program will increase sales, cost savings program</td>
<td>Combination of business segments and geographical location</td>
<td>Not disclosed</td>
<td>3 years</td>
<td>Revenue growth 1.5-4%</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Lassila &amp; Tikanoja PLC</td>
<td>The economic downturn will have negative impact on revenue and profitability</td>
<td>Combination of business segments and geographical location</td>
<td>9.6%</td>
<td>5 years</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Metsa Board Corporation</td>
<td>The beginning of 2009 is expected to be challenging for all grades due to the global economic downturn.</td>
<td>Business segments</td>
<td>8.1%</td>
<td>5 years</td>
<td>Not disclosed</td>
<td>Disclosure unclear</td>
</tr>
<tr>
<td>PKC Group OYJ</td>
<td>At present, it is difficult to estimate how long the current economic downturn will continue.</td>
<td>Combination of business segments and geographical location</td>
<td>10.2-12.7</td>
<td>5 years</td>
<td>Revenue growth 5.5-11.6%</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Raisio PLC</td>
<td>In 2010-2011, Raisio will move to a growth phase. We expect a considerable increase in net sales in 2010. The expect a considerable increase in net sales in 2010.</td>
<td>Combination of business segments and geographical location</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Solteq OYJ</td>
<td>For 2012, we estimate that we grow with the market and at the same time we improve our profitability.</td>
<td>Business segments</td>
<td>8.2%</td>
<td>5 years</td>
<td>Revenue growth of 0-20%</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Sponda OYJ</td>
<td>Even thought rental and occupancy rates are expected to fall in 2009, company forecasts higher net operating income</td>
<td>Business segments</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>STORA ENSO OYJ</td>
<td>In Europe market demand is forecast to remain weak and clearly less than a year ago for all the Group’s products, at least throughout the first half of 2009, due to the current economic downturn.</td>
<td>Combination of business segments and geographical location</td>
<td>10.1%</td>
<td>5 years</td>
<td>Not disclosed</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Suominen Yhtyma OYJ</td>
<td>The demand for Suominen’s products is evaluated on the basis of customer demand for Suominen’s products will remain stable in 2011, and no contracts and use forecasts provided by customers. It is estimated that major</td>
<td>Business segments</td>
<td>10.8%</td>
<td>5 years</td>
<td>Revou growth of 3%</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Talentum OYJ</td>
<td>With the general weakening of economic conditions and forecasts, presenting the outlook for 2009 is extremely difficult</td>
<td>Based on geographical location</td>
<td>6.7%</td>
<td>5 years</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Teleste OYJ</td>
<td>In an uncertain market situation, the recent strategic investments made in the services business enable the net sales to grow from the 2009 level.</td>
<td>Business segments</td>
<td>12.3%</td>
<td>10 years</td>
<td>Revenue growth of 10%</td>
<td>Disclosed</td>
</tr>
<tr>
<td>Tiimari PLC</td>
<td>Economic uncertainty, however company's cost saving program is more than sufficient to provide good results even with economic downturn</td>
<td>Business segments</td>
<td>9.3%</td>
<td>5 years</td>
<td>not disclosed, however weakened</td>
<td>Not disclosed</td>
</tr>
<tr>
<td>Trainers House OYJ</td>
<td>Risks in the operating markets has remained same. The cash flows are very hard to forecast because of the business line company. General economic outlook has improved in short term, but long term estimation is weak.</td>
<td>Business segments</td>
<td>9.3%</td>
<td>5 years</td>
<td>not disclosed</td>
<td>Disclosed</td>
</tr>
<tr>
<td>UPM-Kymmene OYJ</td>
<td>Global demand for printing papers is forecast to grow somewhat from the last year</td>
<td>Business segments</td>
<td>8.6%</td>
<td>10 years</td>
<td>not disclosed</td>
<td>Disclosed</td>
</tr>
</tbody>
</table>
Table 2. Goodwill impairment data

<table>
<thead>
<tr>
<th>Company</th>
<th>Year of impairment</th>
<th>Amount of goodwill</th>
<th>Total Assets</th>
<th>Goodwill impairment</th>
<th>% goodwill impairment of total assets</th>
<th>% of impairment of total goodwill of total assets</th>
<th>Goodwill impairment of total goodwill</th>
<th>P.B</th>
<th>P.B t-1</th>
<th>Increase/decrease in P.B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Afarak Group OYJ</td>
<td>2009</td>
<td>€ 172,850</td>
<td>€ 563,200</td>
<td>€ 47,000</td>
<td>31%</td>
<td>8%</td>
<td>27%</td>
<td></td>
<td></td>
<td>1.09037 0.86028 122%</td>
</tr>
<tr>
<td>Affecto OYJ</td>
<td>2009</td>
<td>€ 69,415</td>
<td>€ 136,296</td>
<td>€ 6,207</td>
<td>51%</td>
<td>5%</td>
<td>9%</td>
<td>0.89019 0.78043 14%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aspoc Kemp Group OYJ</td>
<td>2007</td>
<td>€ 3,078</td>
<td>€ 88,972</td>
<td>€ 3,078</td>
<td>4%</td>
<td>4%</td>
<td>100%</td>
<td>1.16427 0.79327 47%</td>
<td></td>
<td></td>
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<tr>
<td>Atla OYJ</td>
<td>2009</td>
<td>€ 157,800</td>
<td>€ 1,101,340</td>
<td>€ 3,000</td>
<td>14%</td>
<td>0.27%</td>
<td>2%</td>
<td>0.71565 0.75514 -5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Biht OYJ</td>
<td>2011</td>
<td>€ -</td>
<td>€ 71,470</td>
<td>€ 2,368</td>
<td>0%</td>
<td>3%</td>
<td>100%</td>
<td>0.7549 2.08945 -64%</td>
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<td></td>
</tr>
<tr>
<td>Capman OYJ</td>
<td>2010</td>
<td>€ 6,406</td>
<td>€ 155,805</td>
<td>€ 3,839</td>
<td>4%</td>
<td>2%</td>
<td>60%</td>
<td>1.653 1.45133 14%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cramo OYJ</td>
<td>2009</td>
<td>€ 137,339</td>
<td>€ 918,361</td>
<td>€ 17,100</td>
<td>15%</td>
<td>2%</td>
<td>12%</td>
<td>1.26217 0.44146 186%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Digia PLC</td>
<td>2009</td>
<td>€ 65,545</td>
<td>€ 112,753</td>
<td>€ 23,837</td>
<td>58%</td>
<td>21%</td>
<td>36%</td>
<td>1.21367 0.5381 126%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finnair OYJ</td>
<td>2011</td>
<td>€ 3,700</td>
<td>€ 2,357,000</td>
<td>€ 1,500</td>
<td>0%</td>
<td>0%</td>
<td>41%</td>
<td>0.46453 0.86863 -47%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finlines OYJ</td>
<td>2008</td>
<td>€ 105,644</td>
<td>€ 1,534,352</td>
<td>€ 3,016</td>
<td>7%</td>
<td>0%</td>
<td>3%</td>
<td>0.60142 1.42846 -58%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Glaston OYJ</td>
<td>2012</td>
<td>€ 53,400</td>
<td>€ 157,990</td>
<td>€ 2,990</td>
<td>34%</td>
<td>2%</td>
<td>6%</td>
<td>0.88962 0.89307 0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Huhtamaki OYJ</td>
<td>2008</td>
<td>€ 402,400</td>
<td>€ 1,952,300</td>
<td>€ 72,200</td>
<td>21%</td>
<td>4%</td>
<td>18%</td>
<td>0.7257 1.05507 -31%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ixonos OYJ</td>
<td>2009</td>
<td>€ 22,826</td>
<td>€ 52,140</td>
<td>€ 7,200</td>
<td>44%</td>
<td>14%</td>
<td>32%</td>
<td>1.32094 0.82094 61%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kemira OYJ</td>
<td>2012</td>
<td>€ 536,400</td>
<td>€ 2,489,000</td>
<td>€ 19,500</td>
<td>22%</td>
<td>1%</td>
<td>4%</td>
<td>1.37953 1.02734 34%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kesko OYJ</td>
<td>2012</td>
<td>€ 154,900</td>
<td>€ 4,375,200</td>
<td>€ 23,400</td>
<td>4%</td>
<td>1%</td>
<td>15%</td>
<td>1.10441 1.1692 -6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lassila &amp; Tikanoja PLC</td>
<td>2008</td>
<td>€ 115,451</td>
<td>€ 477,685</td>
<td>€ 3,090</td>
<td>24%</td>
<td>1%</td>
<td>3%</td>
<td>2.08315 4.35506 -52%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Metsa Board Corporation</td>
<td>2008</td>
<td>€ 51,000</td>
<td>€ 4,505,000</td>
<td>€ 12,100</td>
<td>1%</td>
<td>0%</td>
<td>24%</td>
<td>0.17038 0.65917 -74%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PKC Group OYJ</td>
<td>2008</td>
<td>€ 9,481</td>
<td>€ 187,437</td>
<td>€ 1,197</td>
<td>5%</td>
<td>1%</td>
<td>13%</td>
<td>0.73845 1.88219 -61%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raisio PLC</td>
<td>2009</td>
<td>€ -</td>
<td>€ 444,200</td>
<td>€ 2,100</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>1.29899 0.81967 57%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Solteq OYJ</td>
<td>2011</td>
<td>€ 8,396</td>
<td>€ 17,374</td>
<td>€ 2,087</td>
<td>48%</td>
<td>12%</td>
<td>25%</td>
<td>1.88719 2.30343 -18%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sponda OYJ</td>
<td>2008</td>
<td>€ 14,500</td>
<td>€ 3,166,800</td>
<td>€ 1,300</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0.34 0.97 -65%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>STORA ENSO OYJ</td>
<td>2008</td>
<td>€ 207,600</td>
<td>€ 12,240,000</td>
<td>€ 3,920</td>
<td>2%</td>
<td>0%</td>
<td>2%</td>
<td>0.77819 1.09017 -28%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Suomenen Yhteys OYJ</td>
<td>2010</td>
<td>€ 18,498</td>
<td>€ 119,361</td>
<td>€ 4,906</td>
<td>15%</td>
<td>4%</td>
<td>27%</td>
<td>0.73778 1.02794 -28%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Talentum OYJ</td>
<td>2010</td>
<td>€ 31,700</td>
<td>€ 64,700</td>
<td>€ 2,900</td>
<td>49%</td>
<td>4%</td>
<td>9%</td>
<td>4.96103 5.21032 -5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Teleste OYJ</td>
<td>2011</td>
<td>€ 31,277</td>
<td>€ 133,211</td>
<td>€ 800</td>
<td>23%</td>
<td>1%</td>
<td>3%</td>
<td>0.95649 1.53357 -38%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Timo OYJ</td>
<td>2008</td>
<td>€ 33,287</td>
<td>€ 87,926</td>
<td>€ 5,000</td>
<td>38%</td>
<td>6%</td>
<td>15%</td>
<td>0.52333 1.26446 -59%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Traders House OYJ</td>
<td>2010</td>
<td>€ 25,806</td>
<td>€ 52,572</td>
<td>€ 14,400</td>
<td>49%</td>
<td>27%</td>
<td>56%</td>
<td>0.69723 0.58274 20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UPM-Kymmene OYJ</td>
<td>2007</td>
<td>€ 1,163,000</td>
<td>€ 13,953,000</td>
<td>€ 350,000</td>
<td>8%</td>
<td>3%</td>
<td>30%</td>
<td>1.04634 1.37598 -24%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>Year of merger</td>
<td>Year of impairment</td>
<td>Time between impairment and merger</td>
<td>Abnormal equity returns in 7 day event window</td>
<td>Revenue</td>
<td>Revenue t-1</td>
<td>Decrease of revenue</td>
<td>Operating profit</td>
<td>Operating profit t-1</td>
<td>Decrease of operating profit</td>
</tr>
<tr>
<td>-------------------------</td>
<td>----------------</td>
<td>-------------------</td>
<td>-----------------------------------</td>
<td>---------------------------------------------</td>
<td>---------</td>
<td>-------------</td>
<td>---------------------</td>
<td>-----------------</td>
<td>---------------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td>Afarak Group Oyj</td>
<td>2009</td>
<td>2011</td>
<td>2</td>
<td>-2%</td>
<td>€ 193,359</td>
<td>€ 247,361</td>
<td>-22%</td>
<td>€ 49,886</td>
<td>€ 24,617</td>
<td>-51%</td>
</tr>
<tr>
<td>Affecto Oyj</td>
<td>2007</td>
<td>2009</td>
<td>2</td>
<td>11%</td>
<td>€ 103,006</td>
<td>€ 131,565</td>
<td>-22%</td>
<td>€ 3,587</td>
<td>€ 11,808</td>
<td>-130%</td>
</tr>
<tr>
<td>Ania Oyj</td>
<td>2008</td>
<td>2009</td>
<td>1</td>
<td>-7%</td>
<td>€ 1,315,998</td>
<td>€ 1,336,936</td>
<td>-3%</td>
<td>€ 27,500</td>
<td>€ 38,400</td>
<td>-28%</td>
</tr>
<tr>
<td>Cramo Oyj</td>
<td>2008</td>
<td>2009</td>
<td>1</td>
<td>1%</td>
<td>€ 446,676</td>
<td>€ 579,802</td>
<td>-23%</td>
<td>€ 11,467</td>
<td>€ 91,804</td>
<td>-112%</td>
</tr>
<tr>
<td>Finnair</td>
<td>2007</td>
<td>2011</td>
<td>4</td>
<td>-6%</td>
<td>€ 2,257,700</td>
<td>€ 2,023,300</td>
<td>12%</td>
<td>€ 87,800</td>
<td>€ 13,300</td>
<td>-560%</td>
</tr>
<tr>
<td>Ixinos Oyj</td>
<td>2007</td>
<td>2009</td>
<td>2</td>
<td>3%</td>
<td>€ 67,059</td>
<td>€ 75,115</td>
<td>-11%</td>
<td>€ 8,056</td>
<td>€ 6,123</td>
<td>-165%</td>
</tr>
<tr>
<td>Kemira Oyj</td>
<td>2005</td>
<td>2012</td>
<td>7</td>
<td>-6%</td>
<td>€ 2,240,900</td>
<td>€ 2,207,200</td>
<td>2%</td>
<td>€ 31,700</td>
<td>€ 158,300</td>
<td>-80%</td>
</tr>
<tr>
<td>Lassila &amp; Tikanoja Oyj</td>
<td>2006</td>
<td>2008</td>
<td>2</td>
<td>5%</td>
<td>€ 605,996</td>
<td>€ 554,613</td>
<td>9%</td>
<td>€ 55,498</td>
<td>€ 48,775</td>
<td>14%</td>
</tr>
<tr>
<td>Tiimari Oyj</td>
<td>2007</td>
<td>2008</td>
<td>1</td>
<td>8%</td>
<td>€ 85,644</td>
<td>€ 74,570</td>
<td>15%</td>
<td>€ 5,893</td>
<td>€ 4,329</td>
<td>-236%</td>
</tr>
<tr>
<td>Satama Interactive Oyj</td>
<td>2007</td>
<td>2010</td>
<td>3</td>
<td>12%</td>
<td>€ 15,578</td>
<td>€ 20,463</td>
<td>-24%</td>
<td>€ 15,813</td>
<td>€ 2,115</td>
<td>-648%</td>
</tr>
</tbody>
</table>
Key definitions [IAS 36.6]

Impairment loss: the amount by which the carrying amount of an asset or cash-generating unit exceeds its recoverable amount

Carrying amount: the amount at which an asset is recognised in the balance sheet after deducting accumulated depreciation and accumulated impairment losses

Recoverable amount: the higher of an asset's fair value less costs of disposal* (sometimes called net selling price) and its value in use

* Prior to consequential amendments made by IFRS 13 Fair Value Measurement, this was referred to as 'fair value less costs to sell'.

Fair value: the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (see IFRS 13 Fair Value Measurement)

Value in use: the present value of the future cash flows expected to be derived from an asset or cash-generating unit

Identifying an asset that may be impaired

At the end of each reporting period, an entity is required to assess whether there is any indication that an asset may be impaired (i.e. its carrying amount may be higher than its recoverable amount). IAS 36 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, then the asset's recoverable amount must be calculated. [IAS 36.9]

The recoverable amounts of the following types of intangible assets are measured annually whether or not there is any indication that it may be impaired. In some cases, the most recent detailed calculation of recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period: [IAS 36.10]

- an intangible asset with an indefinite useful life
- an intangible asset not yet available for use
- goodwill acquired in a business combination

Indications of impairment [IAS 36.12]

External sources:

- market value declines
- negative changes in technology, markets, economy, or laws
- increases in market interest rates
- net assets of the company higher than market capitalisation

**Internal sources:**

- obsolescence or physical damage
- asset is idle, part of a restructuring or held for disposal
- worse economic performance than expected
- for investments in subsidiaries, joint ventures or associates, the carrying amount is higher than the carrying amount of the investee's assets, or a dividend exceeds the total comprehensive income of the investee

These lists are not intended to be exhaustive. [IAS 36.13] Further, an indication that an asset may be impaired may indicate that the asset's useful life, depreciation method, or residual value may need to be reviewed and adjusted. [IAS 36.17]

**Determining recoverable amount**

- If fair value less costs of disposal or value in use is more than carrying amount, it is not necessary to calculate the other amount. The asset is not impaired. [IAS 36.19]
- If fair value less costs of disposal cannot be determined, then recoverable amount is value in use. [IAS 36.20]
- For assets to be disposed of, recoverable amount is fair value less costs of disposal. [IAS 36.21]

**Fair value less costs of disposal**

- Fair value is determined in accordance with IFRS 13 Fair Value Measurement
- Costs of disposal are the direct added costs only (not existing costs or overhead). [IAS 36.28]

**Value in use**

The calculation of value in use should reflect the following elements: [IAS 36.30]

- an estimate of the future cash flows the entity expects to derive from the asset
- expectations about possible variations in the amount or timing of those future cash flows
- the time value of money, represented by the current market risk-free rate of interest
- the price for bearing the uncertainty inherent in the asset
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset

Cash flow projections should be based on reasonable and supportable assumptions, the most recent budgets and forecasts, and extrapolation for periods beyond budgeted projections. [IAS 36.33] IAS 36 presumes that budgets and forecasts should not go beyond five years; for periods after five years, extrapolate from the earlier budgets. [IAS 36.35] Management should assess the reasonableness of its assumptions by examining the causes of differences between past cash flow projections and actual cash flows. [IAS 36.34]
Cash flow projections should relate to the asset in its current condition – future restructurings to which the entity is not committed and expenditures to improve or enhance the asset's performance should not be anticipated. [IAS 36.44]

Estimates of future cash flows should not include cash inflows or outflows from financing activities, or income tax receipts or payments. [IAS 36.50]

**Discount rate**

In measuring value in use, the discount rate used should be the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset. [IAS 36.55]

The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset. [IAS 36.56]

For impairment of an individual asset or portfolio of assets, the discount rate is the rate the entity would pay in a current market transaction to borrow money to buy that specific asset or portfolio.

If a market-determined asset-specific rate is not available, a surrogate must be used that reflects the time value of money over the asset's life as well as country risk, currency risk, price risk, and cash flow risk. The following would normally be considered: [IAS 36.57]

- the entity's own weighted average cost of capital
- the entity's incremental borrowing rate
- other market borrowing rates.

**Recognition of an impairment loss**

- An impairment loss is recognised whenever recoverable amount is below carrying amount. [IAS 36.59]
- The impairment loss is recognised as an expense (unless it relates to a revalued asset where the impairment loss is treated as a revaluation decrease). [IAS 36.60]
- Adjust depreciation for future periods. [IAS 36.63]

**Cash-generating units**

Recoverable amount should be determined for the individual asset, if possible. [IAS 36.66]

If it is not possible to determine the recoverable amount (fair value less costs of disposal and value in use) for the individual asset, then determine recoverable amount for the asset's cash-generating unit (CGU). [IAS 36.66] The CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. [IAS 36.6]

**Impairment of goodwill**

Goodwill should be tested for impairment annually. [IAS 36.96]
To test for impairment, goodwill must be allocated to each of the acquirer’s cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated shall: [IAS 36.80]

- represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
- not be larger than an operating segment determined in accordance with IFRS 8 Operating Segments.

A cash-generating unit to which goodwill has been allocated shall be tested for impairment at least annually by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit: [IAS 36.90]

- If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit is not impaired
- If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity must recognise an impairment loss.

The impairment loss is allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order: [IAS 36.104]

- first, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
- then, reduce the carrying amounts of the other assets of the unit (group of units) pro rata on the basis.

The carrying amount of an asset should not be reduced below the highest of: [IAS 36.105]

- its fair value less costs of disposal (if measurable)
- its value in use (if measurable)
- zero.

If the preceding rule is applied, further allocation of the impairment loss is made pro rata to the other assets of the unit (group of units).

**Reversal of an impairment loss**

- Same approach as for the identification of impaired assets: assess at each balance sheet date whether there is an indication that an impairment loss may have decreased. If so, calculate recoverable amount. [IAS 36.110]
- No reversal for unwinding of discount. [IAS 36.116]
- The increased carrying amount due to reversal should not be more than what the depreciated historical cost would have been if the impairment had not been recognised. [IAS 36.117]
- Reversal of an impairment loss is recognised in the profit or loss unless it relates to a revalued asset [IAS 36.119]
- Adjust depreciation for future periods. [IAS 36.121]
- Reversal of an impairment loss for goodwill is prohibited. [IAS 36.124]
Disclosure

Disclosure by class of assets: [IAS 36.126]

- impairment losses recognised in profit or loss
- impairment losses reversed in profit or loss
- which line item(s) of the statement of comprehensive income
- impairment losses on revalued assets recognised in other comprehensive income
- impairment losses on revalued assets reversed in other comprehensive income

Disclosure by reportable segment: [IAS 36.129]

- impairment losses recognised
- impairment losses reversed

Other disclosures:

If an individual impairment loss (reversal) is material disclose: [IAS 36.130]

- events and circumstances resulting in the impairment loss
- amount of the loss or reversal
- individual asset: nature and segment to which it relates
- cash generating unit: description, amount of impairment loss (reversal) by class of assets and segment
- if recoverable amount is fair value less costs of disposal, the level of the fair value hierarchy (from IFRS 13 Fair Value Measurement) within which the fair value measurement is categorised, the valuation techniques used to measure fair value less costs of disposal and the key assumptions used in the measurement of fair value measurements categorised within 'Level 2' and 'Level 3' of the fair value hierarchy*
- if recoverable amount has been determined on the basis of value in use, or on the basis of fair value less costs of disposal using a present value technique*, disclose the discount rate

* Amendments introduced by Recoverable Amount Disclosures for Non-Financial Assets, effective for annual periods beginning on or after 1 January 2014.

If impairment losses recognised (reversed) are material in aggregate to the financial statements as a whole, disclose: [IAS 36.131]

- main classes of assets affected
- main events and circumstances

Disclose detailed information about the estimates used to measure recoverable amounts of cash generating units containing goodwill or intangible assets with indefinite useful lives. [IAS 36.134-35]

(International Accounting Standards Board, 2011)
Appendix 3. Case Studies

Case 1. Afarak group

Company description

Ruukki Group is a chrome mining and minerals producer focused on delivering sustainable growth with a speciality alloys business in southern Europe and a ferro alloys business in southern Africa. The Company is listed on NASDAQ OMX Helsinki (RUG1V) and the Main Market of the London Stock Exchange (RKKI). (OMX Helsinki, 2013)

Management and media view

South African subsidiary of Finnish industrial refining group Ruukki, Ruukki South Africa, has acquired an 84.9% stake in Mogale Alloys, in Krugersdorp, for about R2-billion, it announced on Monday. (Mining weekly, 2009)

Smit (Alwyn, CEO) said the Mogale acquisition was an ideal opportunity for Ruukki, both as a ferrochrome operation and as a base from which Ruukki could expand into platinum and other metals processing.

"As demand recovers, ferrochrome market prices are expected to outperform other minerals, due to limited supply and growing demand," Smit said.

The Mogale transaction expands and diversifies Ruukki's current Turkish and German minerals capabilities of special grade ferrochrome, and gives opportunities to use existing sales channels.

"Ruukki believes that now is a proper time to invest into South Africa, due to the major mineral reserve base in the country, and especially due to electricity supply constraints in South Africa, which will act as a barrier to new entrants at least for the medium term," said Smit.

(Mining MX, 2009)

Market reaction and following Goodwill impairment
Goodwill impairment was done consequently two years after the purchase amounting 40.1 Mill EUR, which is quite notable amount considering the purchase price of 180Mill EUR. During these two years economy took downturn to worse and thus goodwill impairments would have been expected in the asset heavy mineral industry driven by higher real prizes of raw materials. Noteworthy of this case is that Afarak group expects the growth to be 7% in revenue in South-African cash generating unit for the period, which seems to be quite high given the economic conditions in 2011. However company did not disclose sensitivity analysis regarding the goodwill impairment testing in their statements and no further goodwill impairment was done in 2012. Also discount rate for the value in use calculation was not disclosed. While the revenue decreased 22% and operating profit 51% in 2011 compared to 2010, price to book ratio increased 122% compared to year before. This indicates that there was heavy impairments done in asset classes including goodwill. Goodwill impairment made was 8% of total assets. Negative operating profit of 49.8Mill EUR was significant factor pushing the company results down. (OMX Helsinki, 2013)

Conclusion

The driving factor behind the acquisition was diversification and access to the raw materials and access to the limited supply of electricity in South Africa as well as growth of the company globally. While the reason was diversification the company stayed near their core business in minerals. The conclusion for failure would not be the diversification but more of a long term economic downturn as well as the high risk associated with the South-Africa due to a political and environmental risk factors. During the research there was no strong evidence to linking this to the failure factors of Mergers and Acquisitions to the goodwill impairment. It is more conclusive to attribute goodwill impairment to the low P:B ratio as well as maximizing the losses at 1 year in order to avoid heavy impairments in the upcoming years.

Case 2. Affecto Oyj

Company description

Affecto builds versatile IT solutions for companies and organizations to improve their efficiency in business and to support the related decision-making. With Affecto’s Business Intelligence (BI) solutions organizations are able to link strategic targets and business management. Business Intelligence solutions enable the further processing and utilization of information generated by ERP and other IT systems. The company also delivers operational IT solutions, such as Enterprise Content Management (ECM), for improving and simplifying processes at customer organizations. Affecto offers Business Intelligence solutions in its operating areas in the Nordic and Baltic countries. In Operational solutions, the company has a presence in Finland and in the
Baltic region. Affecto is headquartered in Helsinki, Finland. The company has subsidiaries in Finland, Sweden, Norway, Denmark, Estonia, Lithuania, Latvia and Poland. (OMX Helsinki, 2013)

Management and media view

This business combination is important and logical step towards our strategic goal of being leading business intelligence service provider in the Nordics, Baltic area and CEE-countries. With the business combination we will become the market leader in the mentioned areas.

Our company will grow meaningfully and our goal is to reach 115 mill EUR pro-forma revenue in 2007. We have known Component as a company for several years and we know that it is well managed with expertise in a business line. Since the company culture is very similar to ours in Affecto we firmly believe that integration of the acquisition will be very smooth. (Kauppalehti, 2007)

Market reaction and following Goodwill impairment

Even though the market took the acquisition announcement as a huge success yielding 10.9% abnormal equity returns on a seven day event window it took only 2 years for company to impair its goodwill from the purchase. The purchase price was around 40 Mill EUR and after two years the impairment of 6.2 Mill EUR was made. The reasons given for the goodwill impairment was the slow development of the markets due to a financial crisis and thus decreased cash flow expectations. The impairment was made in Baltic cash generating unit. The discount rate used reflects the high risk being as high as 17.26%. Company notes that 1.25% decrease in revenue would cause further impairments, however there was none until the end of 2012. The impairment took place in 2009, when the company’s operating profit was already below expectations (positive every year apart from 2009). The impairment losses pushed the operating profit down further 6.2 Mill EUR, resulting negative operating profit of 6.2 Mill EUR. However, even without goodwill impairment the operating result of the company was weaker than expected. P:B ratio of company rose to 0.89, an increase of 14% from previous year. (OMX Helsinki, 2013)
Conclusion

The reason for acquisition can be defined as a economies of scale and access to the new markets. As the stock market predicted the acquisition to be a huge success, there was no indication of failure reasons of M&A for this case. The company is discounting the cash flows with heavy discount rate and giving more realistic view and growth expectations of revenue are modest. However the impairment was done already in a below expectations resulting year, giving indication that company might have recorded an impairment loss on a year that was already going to have negative impact and may have maximizing the loss at that year and making sure that there will be no further goodwill impairments in the near future.

Case 3. Atria Oyj

Company description

Atria Group Plc is a Finnish food processing company that is going international. The group’s brands are Atria, Duke’s, Forssan, Lithells, Sibylla, Grillköket, Vilniaus Mesa, Maks & Moorits and Pit-Product. The biggest production companies within the Atria Group are:* Atria Oy - meat industry, meat product and convenience food industries and poultry industry.* Lithells AB - meat product industry, convenience food industry, fast food business and wholesale trade.* Liha and Säilyke Oy - salad and convenience food industries.* UAB Vilniaus Mesa - meat product industry.* AS Valga Lihatööstus - meat product industry.* Pit-Product - meat product industry. (OMX Helsinki, 2013)

Management and media view of the business combination

Atria decided to buy the Russian Campomos meat refinery from Russian Federation in June 2008. The purpose of the acquisition is to reach the market’s in the city of Moscow as well as strengthening the position in St. Petersburg area. The acquired company is building another meat-refinery in near of St. Petersburg increasing Atria’s capacity of supplying meat products in Russia. (Taloussanomat, 2008) (Taloussanomat, 2008)

Market reaction and following Goodwill impairment
The stock market reacted on news of new business combination by deeming it to be a huge failure. Over a 7 day event window 7.36% decrease was recorded in abnormal equity returns. Goodwill impairment of 3 mill EUR was made for the Russian cash generating unit in 2009 just a year after the purchase. The company’s view of the goodwill impairment is due to a challenging market conditions, increase in price of raw materials and economic downturn. Riskiness of Russian market was the major reason pushing the stock down at the event window. The company did not disclose the growth expectations for the CGU where the impairment was made. Discount rate used for the value in use calculation was 7.5% for the Russian cash generating unit. This is relatively very low discount rate considering all the risks involved in Russian market. The company did not disclose the sensitivity analysis for the Russian market. The goodwill impairment attributed 0.27% of total assets, making it very insignificant.

**Conclusion**

The major key assumptions for the impairment were not disclosed in the financial statements. This indicates that further impairments might be expected as the management is reluctant to close in important information for the readers of financial statements. Atria has indeed made goodwill impairments to the Russian CGU for the years 2010-2012. However these impairments were smaller than the first impairment in 2009. There was no evidence to linking the failure of business combination to the failure reasons derived from literature. It is more accounted to the country risk in Russia as well as economic conditions in 2009. By all analysis and studies performed there is no evidence of earnings management or linkage to the failure reasons and it seems evident that goodwill impairment was done due to weakening future cash flows.

**Case 4. Cramo Oyj**

**Company description**

Cramo is Europe’s second largest rental services company specialising in construction machinery and equipment rental and rental-related services, as well as the rental and sale of modular space. Cramo operates in fifteen countries with over 400 depots. With a group staff close to 2,700, Cramo’s consolidated sales in 2011 was EUR 680 million. (OMX Helsinki, 2013)

**Management and media view**
Jarmo Laasanen, senior vice president of Cramo Other Europe said: "We are glad to welcome Tapeks Noma into the Cramo Group. Even though we see some slowdown in the residential construction sector in Latvia, the equipment rental sector is still growing rapidly due to the fairly low rental penetration. "Through the acquisition Cramo will become the second largest rental services provider in the Latvian market. Thereafter, with a total of some 54 depots in the Baltic countries, Cramo has very strong market coverage in the Baltic region."

(Vertikal, 2008) (Taloussanomat, Porssi, 2008)

**Market reaction and following Goodwill impairment**

Cramo Oyj’s acquisition of Tapeks Noma was greeted in the stock market with a slight increase of below 1% of abnormal equity returns in a 7 day event window. The goodwill impairment related to this acquisition was due already the next year. The impairment losses of 17.1 Mill EUR was recorded to the Baltic cash generating unit, which of 8.4 Mill EUR was related to Tapeks Noma. In the financial statements the grow prospects has not been closed for the countries, but it is noted that expectations for Baltic is 1.9-19.9%. Quite modest discount rate of 10.12 was used for impairment testing and for sensitivity analysis it was noted that any change to worse in discount rate or growth expectations will result a further goodwill impairment. The company made operating losses of 11 mill EUR during the year, compared to the operating profit of 91.8Mill the year before. Even without the total 17.1 Mill EUR impairment the operating profit would have decreased massively in 2009. The P:B ratio of Cramo increased in 2009 to 1.26, showing a major rise of 186% compared to previous year.

**Conclusion**

There was no indication linking the goodwill impairment to the failure reason of M&A. However it seems evident that goodwill impairment loss was recorded in an exceptionally bad year, indicating that no further goodwill impairments would be necessary in the next years. However Cramo also impaired its goodwill in 2010 and 2011 but substantially lower amounts. Also the result is effected by impairment of other assets than goodwill as well. It can be concluded that the impairment was made on exceptionally bad year, avoiding future goodwill impairments.

**Case 5. Finnair Oyj (Aurinkomatkat Oyj subsidiary of Finnair)**
Company description

Finnair's goal is to be the leading Northern European aviation service enterprise. The growing Eastern market will increase Finnair's Asian traffic and the subsidiaries Aero and FlyNordic are delivering its services in the Baltic region and the Nordic countries. The Finnair Group contains of:* Scheduled Passenger Traffic - responsible for regular passenger and cargo traffic as well as passenger service on aircraft, the business area's tasks also include route network planning, fleet management and cooperation with other airlines. * Leisure Traffic - produces charter and leisure flight services mainly for tour operators. * Aviation Services - forms a diverse service chain that has a key influence on Finnair's brand and overall service quality, it also embraces ground handling, catering functions and technical services.* Travel Services - provides travel planning and travel management services, the travel agencies Area and Finland Travel Bureau are also included here. (OMX Helsinki, 2013)

Management and media view

Expansion to areas near Finland is natural development for Aurinkomatkat, as the growth possibilities in Finland became limited according to CEO Jukka Salama. Our market share in Finland is 40%, so the limits of market share are very close. We have been looking already over a year for a possibility to expand to Russian markets, Salama continues. (Taloussanomat, Harrastukset, 2007)

In business combination with Calypso we will penetrate the fast growing Russian travel markets. Our target group is upper middle class, who are willing to travel and see the world. (Taloussanomat, Markkinointi, 2007)

Market reaction and following Goodwill impairment

The market reacted to the announced acquisition by deeming it an unsuccessful acquisition. In the 7 day event window 6.32% negative abnormal earnings were recorded. Consequently Finnair Oyj recorded an impairment charge of goodwill in 2011, 4 years after the acquisition in 2007. Modest 10% discount rate was used for impairment testing, considering volatile and risky Russian market conditions. Further analysis to the financial statements shows that the operating profit was 560%, lower than the year before totaling the amount of -87.8Mill. Further recorded impairment losses partly constituted to the higher losses. However the amount impaired of 1.5 Mill EUR was insignificant and Finnair shows exceptionally low amount of goodwill in its financial statements.
Conclusion

The reason for merger and acquisition was the access to the new markets abroad. As this is not considered as a normal failure reason, no conclusion can be made in linking the M&A to a failure reason. However it is evident in this case that the company decided to record the impairment losses on a year that was already below expectations, making it possible to earn more profits in the upcoming periods. However given the company’s revenue and operating profit levels 1,5 Mill EUR impairment does not have significant impact on the financial statements, so it is inconclusive if the impairment loss was recorded to maxima losses in one year.

Case 6. Ixonos Oyj

Company description

Ixonos Plc, formerly known as Tieto-X, operates in the information and communication technology service markets producing customer specific technology consulting, project management and software production services for advancing competitiveness and risk management. Ixono’s clientele comprises mobile and smartphone manufacturers, mobile network suppliers and telecom operators operating on the global markets as well as Finnish finance, industrial and service companies and public administration organizations. Ixonos has its headquarters in Helsinki, Finland, and other local offices in Espoo, Jyväskylä, Kemi, Oulu, Salo, Tampere and Turku. (OMX Helsinki, 2013)

Management and media view

Knowledgeable employer base, the service segment and customer base of LCS are supplementing Ixono’s business and we believe that together we can increase substantially our customer base according to Ixonos CEO Kari Happonen. (Taloussanomat, IT Viikko, 2007)

IT service company Ixonos reported purchase of mobile and internet services producing Cidercone Lice Cycle Solutions shares. The purchase amounts approximately 9 mill EUR and Ixonos’ share increased 4% after the reported acquisition.

(Taloussanomat, Porssi, 2007)
Market reaction and following Goodwill impairment

As quoted above, the stock market reacted positively on the acquisition announcement. 7 day event window 2,92% abnormal equity returns. The purchase was made in 2007 and consequent goodwill impairment 2 years after in 2009 for the amount of 7,2 Mill EUR. The discount rate used was 12.7%, which is quite modest to the risk associated to IT services business. According to financial statements of the company the goodwill impairment was due to weakened market conditions of IT service sector. Deeper analysis to the financial statements of 2009 seems to continue with a trend of impairing in a bad year. In 2009 company recorded negative amounts for operating profits of -3.9 Mill EUR compared to previous year 6.1 Mill profits. Ixonos shows high balance of goodwill in it’s statements, constituting 44% (after impairment). The goodwill impairment of 7.2 Mill EUR was a major factor constitution the operating losses. As a consequence of impairment the P:B ration increased to 1.32 from 0.82 of the previous year.

Conclusion

The reason for M&A can be defined as economies of scale. This is not considered to be failure reason and there were no hard evidence linking the acquisition to the failure reasons for M&A activity. It seems that the company impaired the goodwill again on the year that was already going to profit profits below required return and to avoid near future impairments of goodwill.

Case 7. Kemira Oyj

Company description

Kemira is a water chemistry company which focuses on businesses that have water treatment knowledge as their uniting factor. Kemira’s customers’ need for the efficient use of water, water recycling and water treatment is showing very powerful future growth. To meet the resulting demand, Kemira provides an extensive product portfolio and leading competence in chemical water treatment and fiber chemistry. Kemira’s core business consists of three customer-oriented segments: Paper, which serves the pulp and paper industry; Municipal & Industrial, serving both municipal and industrial customers; and Oil & Mining for customers in the oil and mining industries. These segments all use the same product know-how, product portfolio and chemistry, which Kemira have built through dedicated research and development work and
numerous acquisitions. In addition, ChemSolutions is part of Kemira, serving customers in the food and feed markets and in the pharmaceutical and chemical industries. (OMX Helsinki, 2013)

Management and media view

On Monday morning, Kemira announced that it would acquire all stock in the Dutch speciality chemicals company Verdugt BV for EUR 148 million from the company’s current operative management and the international private equity firm CVC Capital Partners.

(HelsinginSanomat, 2005)

The acquisition price is reasonable, considering Verdugt’s profitability and the synergy benefits. We also expect the deal to raise Kemira’s result as early as during our first year of operation, says Harri Kerminen, President of Kemira’s Industrial Chemicals SBU. With the acquisition Kemira advances in the value chain in accordance with the Group’s strategy, moving towards products with added value.

(Eurinvestor, 2005)

Market reaction and following Goodwill impairment

The market deemed the acquisition as unsuccessful one and Kemira’s stock showed negative abnormal earnings of 6.48% in the 7 day event window. However there was another acquisition announced in the same event window, which will add noise to the deeming this singly acquisition as success or failure. The acquisition was made at 2005 and it took 7 years, until 2012 that the impairment losses were recorded. It was not disclosed what is the exact amount of goodwill impairment related to purchase of Verdugt B.V., but the statements disclosed that impairment of 19,5 Mill EUR was “mainly” related to the Vedugt B.V. Looking in detail to the financial statements The year 2012 was already going under the expectations before the impairment charges. The impairment charge of 19.5 Mill EUR had a significant impact on operating profits. However these were already way below the expectations of the market, indicating that goodwill impairment was made in a bad year.

Conclusion
The reason for business combination is combination of accessing markets, diversification and economies of scale. None of the above mentioned reasons can be linked reliably to the failure reason of mergers and acquisitions. As the operating profit of the company decreased for the year under scrutiny it could signal the incentive for earnings management and to avoid future goodwill impairments. The amount of goodwill impairment is significant factor constituting the lower operating profits, but the decrease of 120Mill EUR in operating profits is clearly not subject only to goodwill impairment.

Case 8. Lassila & Tikanoja Oyj

Company description

Lassila & Tikanoja, is a Finnish company specialising in environmental management and property and plant management. L&T is operative in Finland and increasingly also in other countries in the Baltic region. L&T’s services are split into three divisions: * Environmental Services - covers the collection, transport and treatment of waste and reusable material and the supply of processed recycled materials for reuse. * Property Services - comprises property maintenance and cleaning services. * Industrial Services - specialises in heavy-duty cleaning and damage repair for industry and other types of property that require special expertise. (OMX Helsinki, 2013)

Management and media view

Jari Sarjo, CEO of the L&T is made the following remarks of the acquisition: The Swedish market are challenging but interesting. We have spotted a niche in the markets for a significant player with a special focus in the quality of services. L&T is aiming for strong growth in the Sweden by acquisitions. Our aim is to be in couple of years one of the leading providers of cleaning services in Swedish markets.

(Taloussanomat, Arkisto, 2006)

Market reaction and following Goodwill impairment
The stock market reaction in a 7 day event window was highly positive for the business combination. The abnormal equity returns were for the event window 4.88%. However it only took two years for the following goodwill impairment related to Swedish CGU and the goodwill impairment of 3.1 Mill EUR was made in 2008. The company quotes in their financial statements that the reason for impairment was weakened market conditions in Sweden. The discount rate of 9.6% was used. The M:B ratio of company had dropped from previous year’s 4.36 to 2.08. Partly as a result of impairment the next year’s M:B ratio increased to 2.86.

Conclusion

The reason for M&A activity for this case it to access the new markets. This is not a failure reason for the merger and acquisition so the case can’t be linked to the failure reason. This case is quite remarkable since the company showed increased revenue and operating profit for the year 2008. It is signaling towards that the goodwill impairment was done partly due to a low valuation of the company’s market value by stock markets. However the impairment amount was very small compared to total assets or goodwill balance. The company stated in their financial statement that they expect economic downturn to have very little impact on the business segment they are specialized in. This seems to hold true and is only one of the analyzed companies that does not show correlation between earnings and goodwill impairment.

Case 9. Tiimari Oyj

Company description

Tiimari is Finland’s leading nation-wide chain of stores specialised in stationery, craft and hobby, gift, home and decoration items. Tiimari’s basic promise is to offer “fun and useful products for everyday or festive use, at low prices,” and each Tiimari store fulfils this promise every day. (OMX Helsinki, 2013)

Management and media view

With the acquisition Tiimari is expanding strongly to the Nordic markets. After the business combination Tiimari owns around 300 shops in seven countries.
Tiimari has calculated the uprising synergies to amount over 1 mill EUR. The synergies are expected to have full effect on the next 2 year period.

(Taloussanomat, Kauppa, 2007)

Market reaction and following Goodwill impairment

The stock market reaction was highly positive for the acquisition. Abnormal equity returns were 8.41% in a seven day event window. Tiimari made the purchase in 2007 and impairment followed 1 year later in 2008. The amount of impairment was 5 Mill EUR. It was the first year that Tiimari reported losses and conclusion can be made that the impairment loss was recorded partly due to already loss making financial period. The discount rate of 9.5% is rather low compared to economic expectations of future in 2008. In their financial statements Tiimari announced that the operating risks do not change for the upcoming years and profitability is expected to increase. The operating profit decreased from 4.3 Mill EUR to 5.8 Mill loss in the year of impairment. Impairment recorded was 5.0 Mill EUR, so roughly half of the operating profit decrease constitutes from goodwill impairment. It is to be noted that company would have made the operating losses regardless of goodwill impairment.

Conclusion

The acquisition can be linked to the diversification as Tiimari bought another shop chain. However the chain is selling similar products as Tiimari, so the failure reason can not be accounted to diversification. It seems more likely that the intention was to impair enough to make base for future profitable periods. However the economic downturn took heavy toll on Tiimari, against the expectations of management and the company has filed a bankruptcy in 2013 after making losses since 2008. Based on this case it seems more evident that the company had motives to attempt earnings management during a bad year than actual cash flow forecasts of the management.

Case 10. Satama Interactive Oyj

Company description
Trainers’ House Plc provides services for boosting business growth. The company was formed by the merger of Satama Interactive Plc and Trainers’ House Ltd on 31 December 2007. The group employs approximately 400 professionals. Offices in Finland are located in Helsinki (Ruoholahti and Hernesaari), Tampere and Turku. International offices are in Düsseldorf, Stockholm and St. Petersburg. (OMX Helsinki, 2013)

Management and media view

The board of the both companies agreed that the merging the business is in accordance to their growth strategies and it is reasonable both, from economic and business perspective to merge.

(Taloussanomat, Tyomarkkinat, 2007)

This case has been discussed in the media quite a lot and as a consensus it can be summarized that the Satama overpaid highly over the Trainer’s house and the expected synergies were not as profitable as expected. There was a huge hype around the merger, but company failed to deliver the expected profits at the end.

Market reaction and following Goodwill impairment

Markets took the merger in very positive manner. In a 7 day event window the company’s stock recorded 11.54% abnormal equity earnings. Merger happened in 2007 and consequent goodwill impairment of 2010. The amount impaired was 14.4 Mill EUR. Already 2008 the company was placed on a risk list due to it’s high amount of goodwill and in the press it was expected to make impairments or suffer heave losses in market value of the company. The market value of the company kept plummeting until 2010 when the impairments were made. The stock market reacted to the impairment announcement by sending the stock to 3% rise in one day. Here it is evident that the company made the impairment based on the market expectations and declined market value. If the impairment testing would have been done on realistic basis the impairment losses should have already been recorded in 2009 and 2010, when the company was making big losses and it became evident that the synergies expected weren’t there. The discount rate dropped from 2009 10.2% to 9.31% in year 2010. Thus the expected cash flows has been decreased vastly.

Conclusion
In this merger the failure reason indicates big case of management Hubris. However the hard evidence of linking this to Hubris alone is missing. It seems more plausible that the management decided to impair the goodwill as a result of decreased market value. However the company was bought in the middle of the hype for company coaching and was lead to success in the earlier years by the most famous Finish company coach Jari Sarasvu. It is evident now that the growth expectations were way too high as well as purchase price compared to what would have been realistic. Later on company did further impairments of goodwill in 2011 and 2012.

Appendix 4. Interview

Semi structured Interview with Gijs Bellekom.

Foreword:

As the interviewee has left the company at the end of September and no official request was made, the interview is made using the interviewee’s personal expertise in the matter. The interviewee has worked 9 years in auditing, latest as an auditing manager and has extensive knowledge about auditing and accounting. This is not representing the official opinion of any of the big four companies. Currently interviewee is working in international company in internal audit function. The interviewee wishes that the company he worked for remains unnamed due to reasons mentioned above.

Please not that this is a summary of the interview and not a detailed transcript.

1. Mergers and acquisitions were very popular before the financial crisis in the 6th wave of M&A in 2002-2008, have you seen as a result more companies reporting big amounts of goodwill in their balance sheets?

   For the time period before 2004 it is impossible to assess as my experience covers only period from 2004 onwards. It is difficult to compare also to the time before as I was not working during that time. But from my point of view, there are no significant amounts of goodwill in the balance sheets of companies. It is highly dependable on the industry and usually manufacturing companies have less goodwill than the IT companies for example. It is quite industry specific as some industries involve more M&A strategies as means of growth than other.

2. In your opinion, what are the most common reasons that M&A activity fails to create expected synergies and shareholder value and thus followed by goodwill impairments?

   Usually the M&A decisions are made on a high level and management has tendencies towards being overly optimistic about their M&A activities. The usual consensus is that the management believes that the M&A will be successful. We also need to keep in mind factors that influence the purchase price. Original valuations are done to with optimistic mindset and due diligence check are used to support the decisions – not in order to pull away from proposed M&A. You also need to keep in mind that management is trying to capitalize minimal amount of goodwill. Firstly everything is
capitalized as identifiable assets and the remaining unidentified amount is capitalized as goodwill. But from my point of view I would say that the most common reason is management being overly positive and optimistic.

3. The goodwill impairments are obviously a hot topic at the moment in the auditing field, have you seen a rise in the goodwill impairments as a result of the economic downturn that started in 2008?

The amount of goodwill impairments that I have audited is not sufficient enough to form solid conclusions. The market conditions of course effect the impairments. What is noteworthy is that goodwill impairment is usually a onetime charge. It is very rare to see goodwill impairments in successive years for the same cash generating units. But as said, the sample is too small for me to make solid conclusion if there has been more or less goodwill impairments.

4. Based on your expertise on the field, what are the most common reasons for goodwill impairments as stated by companies? (Do the companies blame economic downturn)?

Market conditions in generally quoted often in the financial statements. Also other reason quoted is the change in accounting estimates, which includes changes in weighted average cost of capital due to a change in interest rates. It is more likely that companies blame external reasons and not internal ones.

5. Goodwill being infinitely lived asset; it gives a rise for a chance for companies to use it for earnings management. Have you seen signs of this in the companies you have audited?

It is very hard to prove if there is earnings management or not and what are the management’s intentions. It is not evident in most of the cases. Of course there are exceptions, but in auditing it is very hard to prove. You can always challenge the management opinion but neither of you have the crystal ball to see the future and who’s estimate is correct. It is important to keep in mind that usually management has good intentions, even they might seem as earnings management to outsider. But to answer the questions, no, I have not seen earnings management related to goodwill impairments.

6. The impairment test is done usually based on value in use. In your opinion, do the companies assess the value in use realistically?

Management tends to have too positive view in 9/10 cases. On the other hand it is very hard to challenge the management view. In auditing we don’t have crystal ball either to see the future. But purely from auditing point of view, we rather see higher than lower impairments as auditing is based on conservative accounting. But as said it is really hard to tell as goodwill at the end is with infinite life and that basically means assessing the infinite future.
7. What about the discount rate? Based on your experience, does it differ a lot between the companies? Do you account that to the different risks in the businesses or is there some signals that management assesses the discount rate based on something else than reality?

   From my experience the discount rate in the Netherlands is between 5-10%. This is based on the risk of the business. IT companies tend to use higher discount rate of 10% while the manufacturing companies are closer to 5%. It is important to keep in mind that the ways of financing has an impact on weighted average cost of capital, which in turn is used as a base for discount rate. In my opinion the risk of the business is the underlying factor here. I have not seen any signals of management manipulating the discount rate on purpose.

8. While doing my research the companies that were researched seemed to do the goodwill impairments in an exceptionally bad year. Have you seen indication of earnings management in goodwill impairments and goodwill accounting?

   As we discussed before there is no hard evidence and they are very hard to prove. I can’t personally point to any situation where there has been evitable earnings management relating to goodwill impairments or goodwill accounting in general.

9. In Finnish GAAP the goodwill used to be amortized on straight line basis, what do you think are the main advantages of capitalizing goodwill as an asset with infinite life compared to straight line amortization?

   There are several advantages of capitalizing goodwill. The major advantage is that goodwill impairment testing can and should be done in cases of special events that affect the fair value of goodwill. Straight line amortization does not take these events in to account. Also this provides better comparability between companies as for straight line amortization companies could use period from 5-20 years. Goodwill impairment testing gives better and more truthful picture of the company’s actual results.

10. Is the impairment testing that is done now, in your opinion, sufficient enough to companies show the real nature of their business in their financial statements, or is it just making the balance sheets of the companies bigger without representing the real value of the company?

   The question is bit unclear, but in theory the system used at the moment is very good. Like with all the financial decisions for longer periods it is hard to assess accurately the fair value of goodwill. As said it is impossible to predict the future accurately which in turn means that goodwill impairment test is very hard to do accurately.

11. Do you think the disclosures in financial statements are sufficient enough to provide the reader with transparent and correct picture of the company financials? If not, what would in your opinion make it easier to read and understand? (For example I found that sensitivity test is not disclosed, making it very hard to assess the future implications of goodwill impairments?)
In my opinion disclosures can be always better. From what I have seen companies try to disclose the information that is required by accounting standards. Sometimes companies are not able to fully comply and we call those disclosure deficiencies. When using sensitivity analysis as an example, it is important to keep in mind that how big these disclosure deficiencies are? Would they have big impact for the perception of the reader?

12. What is your honest opinion about goodwill accounting? Would you prefer amortization or impairment testing?

It is very hard question, it is like asking a police officer what they think about certain law: They are not making the laws, they are making sure that everyone else including themselves follow it. Amortization would be easier and not so subjective to management positivism. However impairment testing is far superior because it captures the triggering events and it should reflect the fair value of goodwill. The both ways have their advantages, but in terms of providing more truthful picture of the company goodwill impairment testing as it is now is better.

13. To conclude the interview, what is your view about goodwill accounting and impairments, what are the biggest problems underlying it at the moment? And on opposite, what are the biggest advantages of having goodwill as an asset with infinite life?

The biggest problems related to goodwill impairments are subjectivity and that looking accurately in the future is impossible. The biggest advantages are that it gives more realistic picture and when the test is done objectively it is the most accurate way of measuring the fair value of goodwill.