Advances in Accounting, incorporating Advances in International Accounting 26 (2010) 333–339

Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

Goodwill write-off and financial market behaviour: An analysis of possible relationships

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ARTICLE INFO

Keywords:
impairment
impairment test
IAS
financial accounting
market reaction
goodwill
write-off
goodwill charge
goodwill write-off

ABSTRACT

The aim of this contribution is to verify whether there exists a reaction of financial markets to the new accounting method for goodwill introduced by SFAS 142 and IAS 36. Our research hypothesis is that financial markets should have no significant reaction to the goodwill write-off following the impairment test, since the latter's outcome represents an economic estimate without financial significance. The hypothesis was checked by the analysis of the companies added to the Standard & Poor's Europe 350 index over a three-year period, taking note of goodwill write-off announcements and relating them with the stock market prices and their volatility. The results demonstrate a correlation between the goodwill write-off and the behaviour of financial markets, while the same connection cannot be evinced for prices volatility. Also, what comes out from our analysis is that markets need a relatively long period, over one semester, before absorbing in full the effects resulting from the write-off announcement.

1. Introduction

Nowadays, intangible resources are of fundamental importance for the life cycle of economic entities. Even though the relevance of intangibles is generally acknowledged, there is a significant debate over their identification and evaluation (Mard, Hitchner, Hyden, & Zyla, 2002).

The appraisal of the concept of goodwill falls in this context, and this is why it constitutes one of the most complex and awkward challenges for scholars, also because, as a matter of fact, it must be somehow considered as the most intangible of intangible assets. At the same time, it is worth to note how the common expression "intangible assets and goodwill" suggests that the latter is not wholly comprised in the conceptual category of intangibles.

In line with this understandable theoretical difficulty, the accounting technique put forward a variety of methods to identify and evaluate goodwill. The most followed worldwide reference point, at least at the European level, is offered by the IAS–IFRS, which partly kept to some US accounting principles and choose to stick to the rationale of impairment test, applying it also, and specifically, to goodwill.

Many scholars ventured into the description of impairment dynamics and tried to understand what might be the overall impact of goodwill on investors and on financial statement information (Dogra, 2005; Hayn & Hughes, 2006; Herz et al., 2001). The debate was started in the United States, where the methodology of impairment testing was introduced for the issue under exam relating to operations taking place after 30 June 2001, and following the guidelines drawn in the Statement of Financial Accounting Standard 142 (Table 1).

Some scholars have pointed out that the impairment tends to be a compromise bearing more disadvantages than advantages, due to the high potential for manipulation of the methodology (Massoud & Raiborn, 2003).

Other scholars, instead, did not identify substantial changes in the financial statement disclosure, and argued that not even the new accounting method managed to provide investors with a real view of business combinations (Ellis, 2001).

Table 1
Literature review.

Authors	Year	Support/Oppose the transition
Ellis	2001	Neutral
Basi and Penning	2002	Support
Watts	2003	Support
Massoud and Raiborn	2003	Oppose
Davis	2005	Support
Beatty and Weber	2005	Support
Sevin and Schroeder	2005	Support
Churyk	2005	Support
Anantharaman	2007	Support
Skinner	2008	Support

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doi:10.1016/j.adiac.2010.08.001

However, the majority of studies remarked an improvement in the quality of information. Other experts have adopted a positive approach toward transition and followed the evidence that had already been provided in literature before the introduction of the impairment test (Elliot & Shaw, 1988; Francis, Hanna, & Vincent, 1996). In spite of this positive approach, they maintained that the quality of the operating result might be somehow invalidated because of the discretion of the impairment procedures (Basi & Penning, 2002; Davis, 2005; Sevin & Schroeder, 2005). In fact, attention was frequently called to the discretion allowed to financial accountants, that might sometimes lead to give preference to so-called “above the line” values and thus avoid writing-off at critical times for the firm's life (Beatty & Weber, 2006; Watts, 2003a,b).

Some scholars point to the improvement of the financial statement disclosure obtained with the introduction of the impairment test, due to this device's capability to reflect the volatility properties of the intangible resources embedded in goodwill (Anantharaman, 2007; Churyk, 2005; Skinner, 2008).

Although, as already stated above, the issue of financial markets' reaction to write-off announcements has been already examined in literature (see, for a general overview, Bartov, Lindhal, & Ricks, 1998), the studies specifically related to announcements of goodwill write-offs are relatively few.

An analysis carried out for the US market highlighted a sensitivity of investors to goodwill write-offs caused by impairment testing (Hirschey & Richardson, 2003). Certainly, we believe the association between goodwill write-off announcements and market reactions constitute an interesting ground for the European market as well.

2. Research aim and hypothesis

Given that the accounting for goodwill is basically an economic and income-related process meant to recreate a match between expenses and revenues, why do this asset and its value raise such a strong interest? And why do financial market operators, investors and professionals pay so much attention to goodwill write-offs?

It is quite enough to recall well-known cases, like those of AOL Time Warner and eBay, to understand how a mistake in accounting treatments can impact on very different aspects of the firm's life. Following these cases, some academics found that goodwill accounting and estimation raised even more difficulties (Weil & Young, 2002), as confirmed by the abnormal extent of write-offs occurring at significant moments of the firm's life, for example a change at the top management. Experts in this field have at once drawn their attention to significant write-off announcements, like those made by AMD (Clark & Gallagher, 2008), Gmac (Cornwell, 2007), Intel (Deffree, 2003), Qwest, Rhodia and Travelport (Schall, 2006).

It is therefore easy to infer that information about goodwill is often looked upon with at least some “suspicion” by professionals, specialised media, and maybe also investors, notwithstanding the international principles laid by the IAS–IFRS and SFAS, which were both set to constitute a link between the market and the firm.

From a strictly financial point of view, the process of goodwill investment is rather simple to describe: we incur in an outgoing cash flow at the moment a business combination is carried out, with the prospect — or, properly speaking, the hope — of gaining from a cash flow incoming over time.

Clearly, an accounting illustration of the same process is more difficult to give, because its line of succession is almost continuous-time, or at least composed by instants so closed that it is nearly impossible to update books for each entry. Besides it is very hard to recognise and identify all future benefits directly ascribable to the goodwill. Hence, the accounting illustration of the process doesn't match with the presentation of the financial side of goodwill investment. However, as already noticed, a great attention is given to the event of write-off, which is unquestionably an accounting device, and market operators certainly attach some importance to it.

Thus, the research question of the present study is whether there exists a cause–effect relationship, or at least a link, between goodwill write-offs and the behaviour of market investors, which might explain the great sensation caused by announcements of such events.

To this end, we assume that markets are built up and organised according to the perfect market theory, which has been the conceptual foundation of dissertations and mathematical models of economic research in pricing and agents' behaviour for the last decades. Following this approach, operators in financial markets shouldn't ground their decision-making pattern on items that result from accounting policies.

Conversely, according to the directives laid down in the IAS–IFRS, goodwill write-offs are considered economic and income-related occurrences, because goodwill takes the form of a payment made in advance for future economic benefits, and its write-off, on its turn, can only take place once the benefits are gained, or when their amount or deadline are modified.[2]

3. Methodology of analysis

Academics have made many efforts over the past decades to analyse and create an information model designed to explain the process of economic decision-making: in other words, they tried to understand how different operators act before an event takes place and how probabilities of that event change any time a new information is provided.[3]

The knowledge status of a specific subject is designated by a set of single pieces of information, which is converted into a “close” set by the rules of algebra of events and the construction of σ-algebras around it. In this way, it is possible to determine the probability for a certain event to take place according to the information a specific individual possesses, which is precisely represented by the σ-algebra. This can be summarised with the following notation:

$$P(E|\mathfrak{J}) \tag{1}$$

that is, the probability for the E event to take place depending on the $\mathfrak{J}$ information possessed.

However, it is also extremely important to make an *ex-post* examination of the events occurred in the markets, in other words to inquire into the possible causes that induced a certain behaviour on the part of the investors. This is indeed the context for the present study, since its purpose is to try to understand whether or not financial markets react to goodwill write-offs made according to the IAS–IFRS.

This undertaking is rather complex not only for the reasons already examined above, but also because of at least two factors:

1. The information about the event under exam, that is the goodwill write-off, is almost never released alone, but it is often accompanied by many other pieces of news. Just consider how the international accounting principles make it mandatory for companies that keep to them — apart from special cases, and certainly not the ones on the agenda — to carry out an impairment test every year. This is usually made by the end of the fourth quarter, therefore at the same time with the publication of the statement for the financial year that has just closed. As it is well-known, this document contains and releases many information for the market, some of which are already known or partly expected, and others completely new.

[2] IFRS 3, Business combination, Section 52: “Goodwill represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised”.

[3] A fundamental review of this issue can be found in Hull (2006).