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**EARNINGS MANAGEMENT IN  
PURCHASE PRICE ALLOCATIONS**

**Effects on analysts' forecasts**

Master's thesis  
in Accounting and Finance

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# 1 INTRODUCTION

## 1.1 Motivation

In free and internationally oriented markets such as in the Finnish markets companies face tight competition. It is challenging to achieve the set goals for growth and the right positioning of the company in relation to competitors seems to be crucial in order to be successful in modern business environment. These objectives seem to demand more rapid changes in business steering than is possible to achieve through traditional organic expansion. At this turbulence acquisitions become a more appealing alternative. It is a quick and straight-forward method to expand a business. Target businesses can be assessed in relation to the set business strategy and when it is strategically suitable, the ownership of another company can efficiently be acquired. Facts support the importance and popularity of acquisition. The Finnish Securities and Exchange Commission RATA announced 2006 that one third of the Finnish publicly listed companies carried out acquisitions in the previous year. Moreover, it is reported that the quantity of restructuring deals in Finland has grown in 2006 and 2007 compared to the year 2005.

On the other hand, at the same time as acquisitions have become more popular, more weight has been put to the reporting of acquisitions. This is due to the implementation of the International Financial Reporting Standards (IFRS) in 2005. In IFRS the starting point in reporting of acquisitions is the market value of acquired assets, which of course equals to purchase price. Then the whole price is allocated to assets according to their fair values and the remainder is left as goodwill (e.g. Spillane 2005, 24; Reilly 2003). In the former system of the Finnish Accounting Standards (FAS) the whole purchase price was regarded as one entity and it was pooled to acquirer's financial statements (Järvinen et al. 1999, 347). The bottom line is that altogether the amendment brought much more disclosure to acquisitions and it has become easier for investors to assess the acquisitions that are carried out.

Another change that came with the implementation of IFRS concerns the nature of accounting standards. The FAS was a normative setting of standards. It gave instructions that how the accounting shall be carried out in every situation. The IFRS on the other hand does not give direct instruction, but creates guidelines that must be followed in financial statements. (Watts & Zimmerman 1986, 7-8.) The goal is to motivate companies to give the fair and true picture of its business and the standard setter promotes this idea above all. Hence, there are possibilities for companies to exploit this consideration in their financial reporting in order to give a favourable picture of their business. (Ball 2006, Dean & Clarke 2005, Cairns 2007.)

Moreover, the depreciation practises were affected. The useful lives of assets are not anymore regulated in detail and in addition to this there is no more depreciation from goodwill or assets that have indefinite useful lives. This leads at least to two clear problems. Firstly, acquisitions are often driven by possibilities to get intangible assets and thereby there is a lot of valuation of intangible assets that is more of an art than a science in acquisition situations. There are many possibilities of manipulation in valuation that are directly connected to earnings management. Secondly, because goodwill is not a subject to amortizations, there is an obligation to carry out regularly an impairment test for it to examine its fair value. This provides companies another opportunity to manage their earnings. The discretion of goodwill is also seen in practise. The Finnish Securities and Exchange Commission (RATA) (2007, 13) reports the tendency of decreasing amount of purchase price allocated to goodwill in acquisitions. On the other hand Kauppalehti (Hertsi 2008, 2) listed on their front page companies that have generated a lot of goodwill on their balance sheet from acquisitions and are in danger to make large write-downs.

The previous matters give the frames, where it is possible for companies to manage their earnings consistently in order to better achieve their financial targets (e.g. Healy & Wahlen 1999; Beatty & Weber 2006). The motivation for managers to manage company's earnings comes from equity markets' expectations and incentive programs that are bound to company's performance. Watts and Zimmerman (1986) have in their study separated three incentives for executives to manage earnings. Firstly, there is a bonus plan hypotheses, according to which managers choose an accounting procedure that maximise their bonuses. Secondly, there is the debt/equity hypothesis. It states that managers are likely to choose an accounting procedure that suits best to firm's debt covenants. The third defined incentive is called the size hypothesis according to which the size of the firm affects its likeliness to smooth incomes.

All in all, it is clear that acquisitions are an important matter in developing business. On the other hand, the most critical change affecting acquisitions has been the implementation of IFRS for listed companies in the EU. From investors' point of view the implementation was two-faced and the contradiction provides me the fertile ground for a research to examine what is the outcome when the best part, additional level of disclosure, and the worst part, possibility for earnings management through fair value accounting, is put side by side. To combine the introduced matters and study the topic, I examine reporting of acquisitions and especially purchase price allocation (PPA) that is a compulsory part of reporting for companies applying IFRS.

The stress that has been put on purchase price allocation reporting in IFRS appears in the standards. One sign of the importance is the separate standard IFRS 3 Business Combinations that regulates specifically acquisitions. Moreover, the standards IAS 38 Intangible Assets and IAS 36 Impairment of Assets are regarded in allocation situations.

IAS 38 above all instructs the valuation of intangible assets and IAS 36 concentrates on the valuation of assets that do have indefinite useful lives, such as goodwill.

Events deviating from the decisions made in the purchase price allocation affect directly company's profit, which again reflects instantly to the company's market value. Because capital markets affect strongly to decisions that are made in allocation of purchase price, it motivates me to examine the topic from financial markets point of view. The financial markets are, in turn, best described by concentrating on stock analysts, because they should behave rationally in every circumstance (Keane & Runkle 1998, 769). And although they would not always be rational, they form the most rational group of capital market participants, which can be reliably identified. (Schipper 1991, 106.)

Despite the significance of PPA, the concept is very limitedly covered in academic studies, which might partly be explained by the short history of purchase price allocations. There are only some studies concentrating on identifying firm and manager characteristics, which affect allocation decisions (e.g. Zhang & Zhang 2007; Rantsi 2005). However, these researches reveal no results concerning the investors' aspect that I am examining. When considering IFRS and earnings management separately, I find vast academic background in both fields. Earnings management has been a subject to study for decades and on the other hand IFRS has been one of the major topics in the past few years. These theories and results provide me guidelines for my study, but I have no results that combine the comparison of the additional level of disclosures and the problems of fair value accounting in IFRS to cases of acquisitions.

## **1.2 Purpose of the thesis**

The purpose of this study is to examine earnings management in acquisitions from capital market analysts' point of view. The examination of this problem is divided into three separate questions in order to make it more concrete:

- What is the significance of purchase price allocation reports in the interaction between companies and capital market analysts?
- Which are the most important parts of purchase price allocation reports from the analysts' point of view?
- How earnings management appears in reporting of acquisitions and how it affects capital market analysts?

In the first question I focus on the significance and familiarity of purchase price allocation reports among analysts. The objective is to learn the meaning of the allocation report for an analyst, who assesses a company as an investment. In addition to just a nominal significance of the purchase price allocation reports, I want to discover



the reasons behind the result. The reasons might be rational and well argued. For example, if a purchase price allocation report is considered very important because it affects directly the profit of a company, the reason is rational. Also, if the allocation report is despised because its meaning is minimal in comparison to the work of analysing it, it is a well argued reason. On the other hand, the reasons can also be based on attitudes or beliefs, which are flaws in the interaction between companies and investors. For example, if the allocation report is not taken into account because an analyst tends to think that it is manipulated, it is a reason. However, it is not well argued because it is not unambiguously identified.

The second question concentrates more on the purchase price allocation report itself. My goal is to find the key elements that are the most valued from investor's point of view. I examine different determinants that affect the outcome of future profits. The examined topics are such as the amount of goodwill that is often likely to cause a sudden loss in the future as a result of an impairment test. Also the effects of different amortization plans are included. In addition to just recognising the most important parts, I am also interested in the implications that analysts draw from certain decisions that has been made in the allocation report.

The third question is actually duplex. Firstly, it discovers that through which accounts earnings management in acquisitions happen. Secondly, it examines how the earnings management affects the forecasts of analysts. This question and the perspective provided by earnings management are important, because opportunistic behaviour is not aligned with the purpose of IFRS and purchase price allocation.

Altogether, the aim with the questions that I have stated is to help us to understand the world that stock analysts face in this issue. The results can help us in developing effective communication between companies and their interest groups.

To ensure that I am able to cover the target group thoroughly, I need to make certain limitations. Firstly, I use only Finnish analysts as my target group. Further requirements are that they work in Finland and analyses Finnish companies. Secondly, I concentrate only on the Finnish publicly listed companies. This is not only because I have chosen the Finnish analysts, but also because factors such as legislation, taxation, and financial backgrounds varies from country to country and might affect the decisions that companies make. On the other hand, the limitations that I have made are not very strict, because the problems of comparability arising from differences in legislation, taxation etc. are quite mild and thereby the received results are rather comparable between different markets.

## **1.3 Data, methods and methodology**

### ***1.3.1 Configuration***

When considering the chosen target group and the nature of the results I want to receive, I carry out this research by survey method. Thus, I am able to cover the target group and, hopefully, be able to generalise the results. A problem that I might confront is the truthfulness of answers because in a survey answers are always opinions, not true acts. Another issue to consider is that most likely I am not able to get answers from the whole group of analysts because they are not willing to or don't have time to take the survey.

The possible problems of generalising, unreliable answers, and incomplete sample would disappear in a quantitative analysis that would be based on a regression analysis. However, that kind of an approach is impossible in this research because of two reasons. Firstly, I would collide to severe problems in building up a model that explains the effects of purchase price allocation reports because it is not possible to describe the relation of earnings management and stock analysts' recommendations with a sensible number of proxies. Secondly, the varied theoretical background hinders the forming of strict hypotheses that are needed in a regression analysis.

Instead, I fulfil the defects of the survey method by carrying out an interview part to understand the underlying factors affecting investors. A qualitative part enlightens the investor perspective because I get reinforcing information to support my results and disputing arguments to raise new aspects into discussion. Moreover, interviews help me to see the topic of my study in a different light and thereby raising new topics for further study.

### ***1.3.2 Implementation***

I started my data collection phase by running a survey (Appendix 1) within the target group that includes Finnish stock analysts. I started to gather a list of analysts by contacting the Finnish society of financial analysts (Suomen sijoitusanalyttikot ry). They kindly helped me by sending their member register. Although the list includes most of stock analysts in Finland, it was a problem that it also included persons who used to work as an analyst, but had at the moment other jobs. The complete list of the Finnish society of financial analysts consisted of 245 members.

In addition to this, I got help from PricewaterhouseCoopers. They gave me a list of stock analysts with whom they have had contacts. The list included 274 names

internationally. By combining the two lists and dropping out the persons that I found out were not stock analysts or analysts that did not work in Finland, I ended up to 142 persons, who became the target group of this study.

In June 2008 I sent the survey to everyone in the target group and asked them to answer the survey or let me know that they are not stock analysts. I received 13 answers and 12 announced that they did not belong to the target group. Thereby, I excluded them from my sample.

A few weeks later I approached the target group for the second time and again received both answers to the survey and announcements that somebody does not belong to the target group. However, this time I got only five new answers and it seemed to be impossible to gather a decent sample of Finnish stock analyst just by hoping them to answer the survey. On the other hand also in the second round 12 announced that they do not belong to the target group, which helped me in gaining a higher answer percent.

I faced some problems throughout the process in recognising the target group. The starting point was good because I had the lists of potential stock analysts. The idea was to clean the lists from persons that are not currently stock analysts. The result that I received 24 announcements telling me that a person does not belong to the target group meant that I did not excel at limiting the target group. I find very likely that I still include in my target group people who do not belong there. However, in the end I had reduced my target group to 118 capital market analysts.

As I had planned I needed to carry out interviews in order to receive more information for the research. I chose interviewees randomly, but I assured that they are not all analysing same industries. Hence, I avoided industry-related opinions that would be sample-wide.

At first I approached five analysts of which three agreed to an interview and two turned me down. I got plenty of information from the three interviews and I found the structure of the interviews very effective. The results seemed pretty robust, but I wanted to carry out an additional interview. I contacted two more analysts and other one agreed to an interview. All the interviewees agreed with me on a time limit of half an hour per interview. Moreover, I sent my interview plan in advance and recorded the conversations to be as effective as possible in the interviews.

I started the interviews by filling in the survey for them. Based on their answers I later asked questions and wanted them to motivate their answers. I also extended the topic to more general discussion concerning acquisitions, earnings management and share valuation (Appendix 2).

The survey was made anonymously and therefore I made the interviews anonymously as well. However, I refer to the respondents in the results section. Hence, I describe them in short to give some background information.

The interviewee 1 works in a publicly listed investment bank that operates mostly in

the Nordic and Baltic countries. His position is stock analyst and he has a work experience of more than five years in the capital market industry. The companies that he analyses are in the sectors of financial services and real estate businesses. The interviewee is confident about his abilities in the position of an analyst, but does not think that he is an expert in the field of acquisitions.

The interviewee 2 works in a publicly listed investment bank that operates in the Nordic countries. The head office is not in Finland, but the Finnish office is in charge of the investments in Finland and has a strong focus on the investment opportunities in Finland. The respondent has gained a lot of experience in the field of finance and has achieved the position of the chief analyst. The companies she follows in detail are in the field of trade such as Kesko and Stockmann. The interviewee seems to be extremely professional in all matters that I took up in the interview.

The interviewee 3 works in a foreign bank that has only investment banking services in Finland. He has graduated from Turku School of Economics a few years ago and at the moment he has a position of a stock analyst. His area of expertise is companies working in the construction sectors. He does not have as much work experience as the previous interviewees had, but he finds the topic of the study very interesting. He is accurate in his answers and opinions, but finds the topics in the interview to be complex and contextual.

The interviewee 4 is working in a big Finnish publicly listed bank. His position is stock analyst, but he is very experienced in his job. Among others he has analysed Nokia already for more than a decade. Otherwise, his expertise covers companies in the sector of information technology. He seems to be much more laidback as an individual compared to the other interviewees. However, he is certain and straight in his answers and opinions about the topics of the interview. He also differs from the others in share analyses. He approaches share valuation from a much broader perspective. He even started the interview by commenting the topic of discussion to be in many ways irrelevant from his point of view because the topic is too detailed. Nevertheless, his interview was as fruitful as the other interviews concerning this study.

## **1.4 Structure of the thesis**

The sections of my study are organized as follows. In the next chapter I introduce the matters concerning business combinations. The aim is to construct a good picture about the topic, which includes the understanding of purchase price allocation process and the motives behind that. The accounting standards that are taken into account when allocating the purchase price are also introduced in detail.

Section 3 on its behalf enlightens the background of earnings management. First, I go

through the possibilities of earnings management in general, which gives me the foundation for building up assumptions about the allocation process. Furthermore, I highlight the ongoing tendencies in earnings management, because the possibilities of earnings management have changed after the implementation of IFRS.

After the section 3, I have covered the theoretical part and it will be possible to move onto the empirical part in chapter 4. Based on the assumptions that I have represented, I structure a survey that tests the existing theory. In addition, I look through a few interviews to acquire additional information about analysts' opinions. Finally, in the chapter 5, I make the concluding remarks and assess the research as a whole.

## **2 BUSINESS COMBINATIONS**

This chapter describes the meaning of purchase price allocation in acquisitions, introduces it from various perspectives and highlights the most important matters to consider when evaluating purchase price allocations.

### **2.1 Definition and formation of a business combination**

In the International Financial Reporting Standards (IFRS) the term business combination is used to refer to the entity that is formed, when a company acquires another company. This entity is obligated to fulfil the reporting requirements that are set in IFRS for business combinations. (IFRS 3.)

A business combination can be formed in many ways, although the basic assumption is that the acquiring company is public and listed, because it is regulated by IFRS. The target party in turn, has no limitations. It can be a public company as well, but often it is a private company or it might even be only a division of a large company.

The process of an acquisition is versatile and its success depends widely on the target company's actions. It is easiest to describe as a step-by-step process (Sherman 2005, 37). The process is always begun from the criteria of the acquiring company and a succeeded acquisition ends up to the point, where the new part becomes integrated to the acquiring party. The steps are shown in Figure 1.

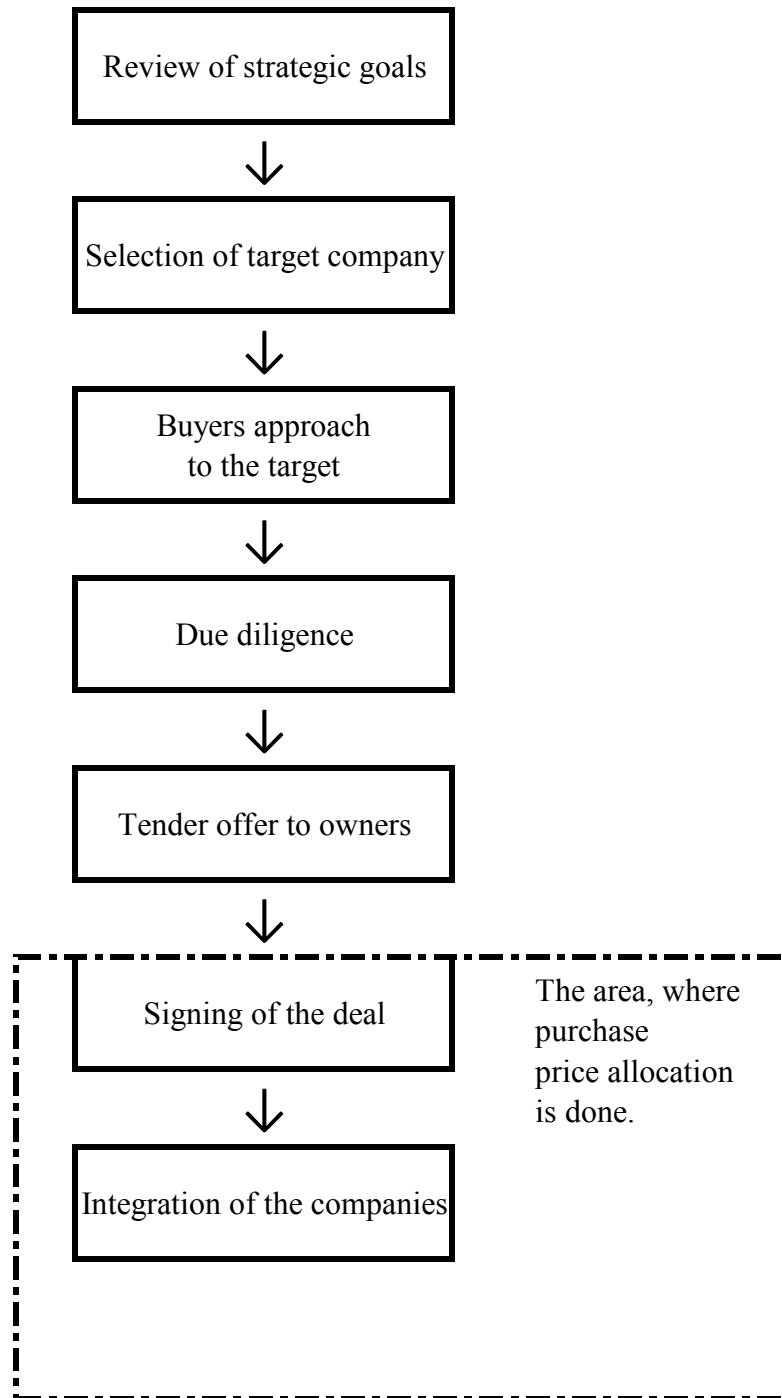


Figure 1 Steps of acquisition and the area which purchase price allocation affects (applied: Howson 2003, 2; Lorange 1987, 9).

Based on the chosen criteria, the buyer chooses a target company and approaches that. Depending on the anticipated attitude of the target company toward the acquisition, different tactics are used. (Whittington & Bates 2007, 30-31; Sherman 2005, 45.) Besides the attitude other things affecting the applied tactics are for example financial information about the target company or ownership structure in the company. These all

motivate the acquirer to think about the alternatives to approach the target. It may approach the owners directly, approach the top management first and then the owners or approach the management, do a due diligence and then make a bid to the owners. The chosen route for making a bid might affect largely on the purchase price allocation that will be carried out after the closing of the deal because the process of due diligence gives the acquirer a possibility to take a look inside the target company. The due diligence analysis aims at solving the compatibility of the target and the acquirer and thereby without due diligence the acquirer does not have the same knowledge about the target's assets as with due diligence (Howson 2003, 3). This again might lead the buyer to make a too high bid because the target seems more valuable to the outside than it really is. (Lorange 1987, 9.)

In the end, it is always the owners of the target company, who make the decision concerning the selling of a company. Hence, the bidder does not have to contact the company management before a tender offer to the owners. The advantage is to surprise the management and eliminate the time that they have to build up a defence in case they find the bid to be hostile by nature. The situation is nearly the same from bidder's point of view in a case where the company management has refused the initial offer before the acquirer represents it to the owners. However, in this alternative the management has more time to set up a defence (Jarrell et al. 1988, 641).

The alternatives that include hostile bids are rather vivid and often very risky, because the acquirer has to make the bid only on the basis of public information. That is why it is desirable that the management agrees with the bidder on the deal. It opens the possibility for the bidder to do the due diligence and the final price in the tender offer is decided based on the results of the due diligence analysis. In case the offer is friendly i.e. the management supports it when it is introduced to the owners, it has better chances to be accepted by the owners. (Sherman & Hart 2005, 45-46.)

Whichever of the ways is taken, the outcome is that the acquisition will eventually be signed and closed. At this point the target company becomes a part of the acquiring company and they form a business combination that is under the rules of the IASB and especially the standard IFRS 3 Business Combinations (IFRS 3: 39). A press release is given and the basic information concerning the acquisition is announced. After this the company begins to calculate purchase price allocation that is made to show the financial situation and the asset breakdown at the date of the acquisition (IFRS 3: 1). It is regulated that the purchase price allocation needs to be done and released within one year from the date of the acquisition.



## **2.2 Purchase price allocation environment**

### **2.2.1 Arrival of IFRS**

The markets of almost all products have become global and on the wave of the change this has happened also to many companies. In addition, the capital markets are in many ways already fully international. These factors drive the need for uniform accounting standards to make company reporting easily comparable (Benston et al. 2006, 3; Rätty & Virkkunen 2004, 23-24) and thereby a notable action towards this was made in the beginning of 2005 as the EU countries made the International Financial Accounting Standards (IFRS) mandatory to apply for publicly listed companies.

The adoption of IFRS was not only the key to uniform accounting standards within the EU states and the rest of the IFRS countries, but also a big step closer to the American US GAAP standards. Subsequently the convergence between US GAAP and IFRS has gone so far in the US that foreign private issuers are nowadays allowed to prepare their financial statements using IFRS without reconciling to US GAAP (Erchinger & Melcher 2007, 123). Moreover, the harmonisation of standards with another important market, Japan, is ongoing. The convergence between the Japanese GAAP and IFRS is planned to be ready in June 2011 (Ikuro Nishikawa, 2007).

On the other hand, in the Finnish context the IFRS adoption meant above all two things. Firstly, the required transparency in financial reporting appeared as a higher level of disclosure than in the Finnish Accounting Standards (FAS). Especially, the amount of appendices grew substantially and caused some problems for listed companies. This can be seen from the settlement of the Finnish Securities and Exchange Commission (RATA) that examined the annual reports of 2005 and 2006 and reported clear deficits in the level of reporting (RATA 2006, 3; RATA 2005, 3). Secondly, the viewpoint to financial accounting became much more balance sheet oriented as it used to be mainly profit and loss statement oriented (Rätty & Virkkunen 2004, 28). In the continental European accounting culture, to which FAS belongs, the reported profit plays the main role and taxation steers amortizations and depreciations (Beaver 2002). In the IFRS setting, the perspective is significantly different. Through the fair value accounting the true potential of assets for future incomes is taken into account and to the valuation of the whole company (Cairns 2007, 80-81).

A purchase price allocation in acquisitions became mandatory for the Finnish publicly listed companies in the beginning of 2005 as IFRS replaced FAS. Under the regulation of FAS the purchase price method was permitted but rarely used in allocation situations because a more straightforward pooling method was allowed. There is a

substantial difference between these two methods and the accounting perspective that came with IFRS can clearly be seen in purchase price allocation. Nowadays acquisitions need to be reported separately in annual reports and the allocation of the purchase price needs to be unveiled (The IFRS Manual... 2006).

### ***2.2.2 The objectives of IFRS regulation***

The purpose of the International Accounting Standards Board, the standard-setter of IFRS regulation, has been to develop accounting standards that require high quality, transparency and comparable information (International Financial Rep... 2004, 4). Ball (2006) states that among other things, this means accurate depiction of economic reality and timelier accounting when it comes to incorporating bad news. To promote this requirement, IFRS emphasises fair value accounting, where assets are evaluated to their most probable value. This should also support accounting quality and for example lower the possibilities for income smoothing.

To fully understand the principal difference between IFRS and FAS, we need to understand the theories of accounting that can be divided into normative and positive (Watts & Zimmerman 1986, 7-8). FAS represents the normative theory because it gives detailed instructions for accounting and leaves no room for consideration. An example is that book values of assets are emphasised and depreciations are based on these. The result is that accounting numbers are comparable between FAS companies, but the true state of issues behind the numbers may not always be unambiguous to external parties. Contrary to this, IFRS represents positive accounting theory that doesn't provide instructions, but instead of that, it gives the frames that what information needs to be announced and what you are not allowed to do. This has been a natural perspective to accounting for IASB because IFRS is applied in more than 100 countries and in this scope it wouldn't be possible to apply normative standards that might be partly in contradiction to existing standards in many countries. (Tilinpäätös inf... 2008; Use of IFRSs... 2008).

IASB has succeeded in the development of IFRS extraordinary well (Ball 2006, 8). However, there has also been some criticism towards the standards. IFRS relies in many situations heavily on the fair value accounting that has been criticised because valuation errors or even manipulation of asset values may happen. Although fair values reflect the values that assets have at the moment, they are just best approximates based on valuation methods (Penman 2001, 442). In the IFRS valuation approach is market, income or cost based depending on the nature of the asset that is evaluated. Most likely the market approach result the fairest value, but for example for intangible assets it is rarely unambiguous. Hence, the valuation is carried out by an alternative method of

valuation, which are in both cases only approximations of incomes or costs and leaves room for management's consideration. (Ball 2006, Dean & Clarke 2005, Cairns 2007).

Originally, the idea of discretionary has been the fairest possible view. It is clear that companies themselves have the best opinion concerning the real value of their assets, but it remains unsolved that how companies value the assets. Companies can be truthful, but IFRS leaves an opportunity for companies to manage their earnings consistently in order to better achieve their financial targets (e.g. Healy & Wahlen 1999; Beatty & Weber 2006).

All in all, the presented issues have so far promoted or on the other hand criticised IFRS. Thus, the IFRS environment is more or less putting things side by side. The best thing is the high level of disclosure and fair values, and the worst part is the possibility to opportunistic behaviour through earnings management and fair value accounting.

## **2.3 Purchase price allocation in practise**

Purchase price allocation describes the process that the acquirer is required to carry out in order to allocate the acquisition cost to the assets and liabilities, which have been acquired in a transaction. The idea is to provide a transparent breakdown of these assets and liabilities (IFRS 3: no more..., 42-43). Moreover, the standards regulate that the assets and liabilities have to be identifiable and meet the recognition criteria. In brief, the recognition criteria are met, when it is certain that the economic consequences will be due to the business combination and, in addition to this, the fair value can be measured reliably (IFRS 3: 36-37).

### **2.3.1 *Cost of acquisition***

The allocation itself begins from the recognised acquirer's cost of capital, which comprises roughly from three components. Firstly, there is the purchase price that is the market of the equity. Secondly, the costs of acquisition, such as consultant fees and transaction costs will be added on the purchase price. The third step is to add the value of assumed liabilities. These components form the base for the allocation of purchase price (Figure 2).

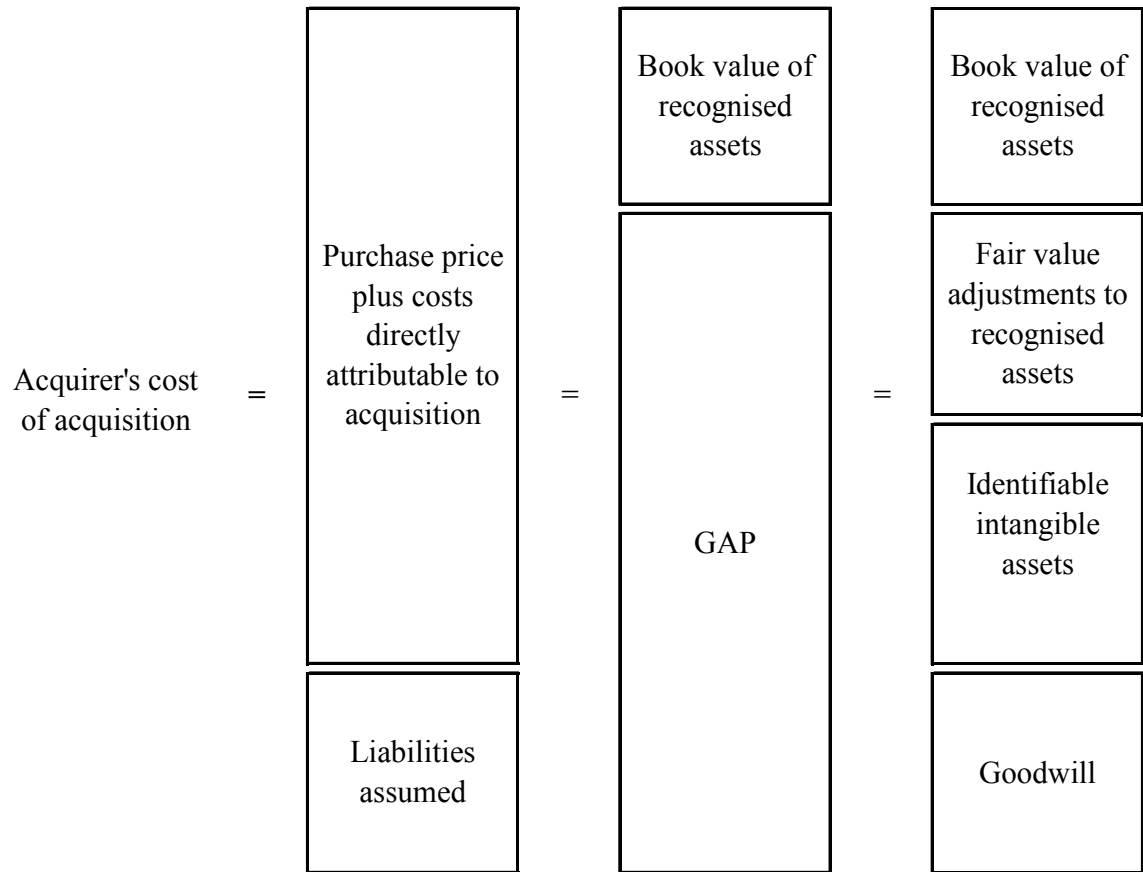


Figure 2 Purchase price allocation (Spillane 2005, 24)

As also shown in the picture, the cost of acquisition rarely equals to the book value of acquired assets. That is why there is a gap. In many cases the gap can be the major part of the paid price. However, the existence of a gap does not directly mean that the purchase price has been too high. It is possible and even probable that not all of the economic benefits coming from the target company to the acquiring company are recognised on the balance sheet of the target company (IFRS ja yrityskaup... 2006, 8). The first step in revaluating the assets is to make fair value adjustments to recognised assets as also described in Figure 2.

In addition, many acquisitions are driven by the possibility to get intangible assets that are not recognised on balance sheet. Within the limitations regulated in IAS 38, these assets can be valued to their fair values and add into the balance sheet of the acquirer (Figure 2). However, only assets that belong to the acquired company are subjects to revaluation. (IFRS 3: IN 7.)

The gap between book values and purchase price is allocated in three steps. Firstly, the recognised assets are revaluated. Recognised assets refer to all the assets that are in the balance sheet of the target company. Hence, valuation is carried out to both tangible

and intangible assets. (Tiffin 2005, 167.)

After the fair value correction, the acquirer tries to identify assets that are not in the balance sheet, but meet the criteria of recognisable asset in the IFRS regulation . The identification process concerns only intangible assets because tangible assets cannot be totally unidentifiable. The intangible assets that are often unidentifiable in the beginning of the purchase price allocation process are internally developed assets that are generated gradually and thus are not recognised in the balance sheet before an acquisition. The remainder of the purchase price is named as goodwill. That describes the value that is not separable from the acquired entity but was worth buying for the acquirer. (Tiffin 2005, 168; Spillane 2005.)

### **2.3.2 Disclosure requirements**

The reporting requirements of business combinations are an essential part of the IFRS 3. There it is stated that an acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that were affected (IFRS 3: 66).

To ensure the correct applying of the disclosing requirements, there is a list of things that needs to be reported in case they have been affected during the period (Appendix 3). The report is in the notes of financial statements under a topic of acquired businesses or a similar topic. In the report, it is mandatory to disclose certain facts about both parties, but most of the information is related to the acquisition target.

Matters such as names and descriptions of the combining businesses are obligatory and concern both parties. In addition, basic information such as acquisition date and price has to be announced. The breakdown of the acquisition cost has to be provided in a general level. This means that assets, liabilities and direct costs of acquisition are separated.

In IFRS, there are vast instructions concerning fair value accounting. However, only intangible assets that has indefinite useful life have to be reported separately. In addition, the decision has to be motivated by giving the reasons that led to the decision.

In case goodwill is generated, it has to be reported in detail. Firstly, the reasons that led to the goodwill needs to be described. Secondly, it has to be explained that which intangible assets are accounted in the goodwill. Also an explanation, why the assets accounted in the goodwill were not separated from goodwill.

## 2.4 Regulative standards

There are above all three IFRS standards that regulate the reporting of acquired businesses. These are IFRS 3 Business Combinations, IAS 38 Intangible Assets and IAS 36 Impairment of Assets.

### 2.4.1 *IFRS 3 Business Combinations*

The standard IFRS 3 sets the guide lines for the accounting concerning acquisitions. The most prominent feature of this standard is the mandatory applying of the purchase method in combining businesses (IFRS 3: IN2, IN7). Therefore, target company's identifiable assets, liabilities and contingent liabilities are recognized in their fair values (IFRS 3: 1). In the Finnish Accounting Standards, the recognition of individual assets was rarely needed, because a more straight-forward pooling of interest method was allowed. On the other hand, also in the standards of the IASB, the IFRS 3 is a rather new standard, because it ousted the old standard IAS 22 Business Combinations as late as in 2004. Before this, also the IFRS allowed the pooling of interest method to be applied.

The purchase method simply means that the cost of the acquired business needs to be allocated to certain assets and liabilities. IFRS 3 actually divides the acquisition cost into four categories: intangible assets, assets other than intangible assets, liabilities and goodwill. The standard provides the allocation requirements for these elements as follows.

Firstly, target's identifiable asset other than intangible asset needs to be separated in case two criteria for the asset become fulfilled. It is probable that any future economic benefits associated to the asset will flow to the acquirer. Moreover, the fair value has to be possible to measure reliably. Secondly, in a case of a liability other than a contingent liability, it needs to be separated, if the following two criteria are satisfied. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and its fair value can be measured reliably. The third case concerns intangible assets. They have only one criterion. Their value needs to be measured reliably. (IFRS 3: 37.) However, I point out that for an intangible asset the reliable measurement is not simple. Therefore, the standard IAS 38 Intangible Assets examines these situations in specific.

The effects of new business combinations shall be incorporated to the income statement of the buyer from the acquisition date. The acquisition date is the moment, when the acquirer effectively obtains control of the target. The standard highlights that the date is not necessary the date when the acquisition is legally closed. It is the moment

when it can be considered that the acquired has obtained the control over the bought entity. (IFRS 3: 39.)

#### **2.4.2 IAS 38 Intangible Assets**

The regulation concerning the valuation of intangible assets is guided in the IAS 38. The starting point for the applying of the standard is the identification of the intangible assets that are applicable to IAS 38. There are two basic conditions of which one needs to be fulfilled. The first option is that the valuated asset is separable from the entity. This point of view stresses the idea that intangible asset is distinguished from goodwill, which is not separately identified although it also generates future benefits. The second option is that the asset arises from contractual or legal rights. This reinforces that the entity controls the asset. Moreover, this satisfies the nature of an asset, because the future benefits are recognised. (IAS 38:12-14.)

Although the criteria of an intangible asset would be met, to be allowed to assess the value of the asset also the recognition criteria need to be satisfied. It has to be probable that the expected future economic benefits that are attributable to the asset will flow to the entity. In addition, the cost of the asset has to be able to measure reliably (IAS 38:21).

At this point, we collide for the first to the discretion that concerns valuation of intangible assets. The IASB instructs that an entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represents management's best estimate of the set of economic conditions that will exist over the useful life of the asset (IAS 38:22). However, the best estimate of the management is open to discretion. Therefore, management's consideration and optimism might be used in order to distort incomes and useful lives of intangible assets (e.g. Wyatt 2005, 968; Powell 2003, 806).

As future economic benefits are one of the required elements in intangible assets, and because it also constitutes the background for valuation of assets, it is defined in the IAS 38 in specific. The 17<sup>th</sup> paragraph says that the future economic benefits received from an intangible asset may include revenue from sales, cost savings or other benefits. Revenue from sales is the most common method and for example a licensed software product is recognised using this method. An example of savings is intellectual property in a production process that reduces the future production costs instead of increasing sales. Finally, the third option leaves more consideration, because it is not defined in the standard what the other benefits resulting from the use of the asset are. (IAS 38:17.)

Intangible assets are in general identifiable non-monetary assets that don't have physical substance (Troberg 2007, 54). Examples of these are computer software and information systems, patents, copyrights, customer lists, franchises, customer and

supplier relationships. Even customer loyalty, market share and marketing rights are intangible assets because they generate economic benefits for the entity.

However, under the IFRS this turns out to be more complex than thought in the first place (Spillane 2005, 25). Depending on the nature of the asset and the way it is acquired, IFRS divides intangible assets into three alternative groups of accounting conventions. Firstly, assets that are separable from the entity, but generated internally shall not be recognised. Brands, publishing titles and customer lists are examples of these. Secondly, all the assets that can be separated from the entity and are externally acquired shall be recognised and valued to their fair value along IFRS. This means that in addition to the assets that have been bought separately, in acquisitions the internally generated intangible assets in the target company are valued as well. (Troberg 2007, 54.) The underlying reason for this slight inconsistency is the applied valuation practise of IFRS. Independent of the nature of the asset, an asset is first time valued on basis of its historical cost and later on to its market value (Kallunki & Niemelä 2004, 193). For example brand is generated internally and it is difficult to assess the resources that have been used. On the other hand, brand is often one of the core assets that is bought in an acquisition and thus its fair value should be defined. In the third group, we have the rest of the intangible assets that are not separated from the entity. They are often regarded as synergy, which is also the residual of the purchase price when the identified assets are recognised. In the balance sheet, this is goodwill. (Spillane 2005, 26; Reilly 2003, 46.)

Intangible assets are essential in the context of purchase price allocation, because targets of acquisitions are often acquired to exploit the unidentified resources (Purchase pri... 2007). In the purchase price allocation the resources are recognised and evaluated. However, there are clear rules that under which conditions the valuation is possible and IAS 38 Intangible Assets concentrates on these requirements.

### **2.4.3 IAS 36 Impairment of Assets**

The objective of the standard is to prescribe the procedures that an entity applies to ensure that its assets are not carried at more than their recoverable amount i.e. fair value. This is the amount that is recoverable through use or sale of the asset. (IAS 36:1.)

The standard is applied in accounting for all assets excluding the assets that are instructed in another IFRS standard than IAS 36 (IAS 36:3-5). This list is rather short (Appendix 4) and it does not have significant effect on purchase price allocation. Although most of the assets are subjects to impairment testing, in practise the impairment of assets that have finite useful life is carried out by depreciations (Troberg 2007, 56).

That is why the most prominent use of this standard concerns assets that have



indefinite useful lives. Namely, one of the most critical amendments compared to FAS is that in IFRS it is not allowed to do depreciations from assets that do not have finite useful life. Examples of assets treated this way are goodwill and often also brands. From the aspect of this thesis, it is important to understand the difference in accounting of assets that have finite useful life and indefinite useful life. Impairment testing is applied especially for assets with indefinite useful life.

From the Finnish Accounting Standards' point of view impairment testing was a substantial amendment. In the FAS, the value of every acquired asset was depreciated within its useful life. The maximum time for depreciations was 20 years and this was widely applied for goodwill. Nowadays, as there is no longer possibility for amortizations, goodwill is subject to impairment testing.

In the IAS 36, the correct value for an asset in accounting is referred as the recoverable amount. It shall be measured in two ways. Firstly, the value can be identified based on a given fair value on the market less costs of selling. The requirements for identifying the value in a sale are high, because there is a recommendation that an evidence of a binding sale agreement in an arm's length transaction should be available. In practise, for many assets, especially intangibles, there is no such market (Kallunki & Niemelä 2004, 201). Independently from the possibilities to recognise a market price, the value should also be identified based on its value in use. The value in use is the result from the valuation models that are applied in IFRS and based on discounted future cash flows. I go through the valuation approaches in the next chapter in detail. Neither are the valuation approaches gone through in IAS 36. (IAS 36:18,25,30.)

When the values of assets are recognised with both methods, the higher value of these is the recoverable amount. Taking the higher value seems to be in conflict with the requirement of prudence. However, we need to remember that above all the fair values are stressed in the IFRS setting. Thus, the higher value describes best the economic benefit that the asset is able to produce. (Kallunki & Niemelä 2004, 201.)

The need for impairment is finally determined when the recoverable amount is compared to the carrying amount in the balance sheet. The impairment should be carried out in case the carrying amount is higher than the recoverable amount. (IAS 36:1.)

## **2.5 Valuation approaches**

Generally IFRS aims at recognising assets at their fair value. This is the value that equals to the price received when an asset is sold, or alternatively, to the income when the asset is in use. From these two, the more straight-forward method is the selling of the asset i.e. the market approach, because a market price is an unambiguous measure of

value. However, often there is no given market price to an asset and the value has to be evaluated based on the economic benefits that are received during the useful life of the asset. This method is called the income approach. (Kallunki & Martikainen 2004, 201-203; Purchase pri... 2007, 5; Spillane 2005, 25.)

In case both of the previous methods seem inappropriate and the best way to recognise the value of an asset is through its cost, it is also approved and referred as the cost approach. However, companies are obligated to use primarily the market approach, then income approach and finally the cost approach if it is necessary. (Kallunki & Martikainen 2004, 201-203; Purchase pri... 2007, 5; Spillane 2005, 25.)

### **2.5.1 Market approach**

The market approach means that the fair value of an asset is the price that can be identified from an active market (IFRS ja yrityskaup... 2006, 22). The IASB has set three conditions for a market to be recognised as an active market. Firstly, assets that are traded in the market need to be homogenous. Secondly, willing buyers and sellers can normally be found at any time. Thirdly, prices are available to the public (e.g. IAS 36, 6). In addition, to be certain that the price equals fair value, the exchange has to be made between knowledgeable and independent parties (IAS 38, 8).

When the set conditions are met, it makes sense that the prices can be applied reliably and they show the real values of assets. This approach works rather well for certain asset groups such as tangible assets. However, the problem is that there are many assets, which don't have active market or willing buyers. This is the situation especially for intangible assets. (Spillane 2005, 24.) Moreover, in the context of business combination, the valuation of intangibles is often the most prominent group of assets and thereby the most important part in the valuation of assets of a newly acquired business (Purchase pri... 2007, 1).

In situations where the fair value is not unclear, but most of the set conditions are met, it is still possible to apply market prices by doing approximations. If the price of a transaction on a similar item is known, a multiple that presents the relation between certain elements of the asset can be calculated. For example, if we can calculate profitability for an asset, we may multiply that to receive an estimate of a market price. (IFRS ja yrityskaup... 2006, 22.) On the other hand, it is often impossible to calculate profitability, because we don't know the future cash flows for sure. If we need to estimate those cash flows, we need to apply another valuation approach, namely income approach.

### 2.5.2 *Income approach*

In the income approach the value of an asset is estimated based on the cash flows that it generates during its economic life. The cash flows are discounted to the present time and added up. Hence, we receive the value of the asset in the present time. This method is very similar to the common discounted cash flow method used in investment decisions.

The income approach is more complex than the previously introduced market approach, because much estimation needs to be used. However, this is the most common valuation approach for intangible assets. Furthermore, depending on the nature of the asset, there are many methods of calculation. The four most common methods are Direct Cash Flow Projection, Relief-from-Royalty, Multi-period Excess Earnings and Incremental Cash Flow. (IFRS ja yrittyskaup... 2006, 33.)

Direct Cash Flow Projection is near the usual cash flow discounting method, but the difference is in the applied discount rate. In this method the rate varies from an asset group to another depending on the asset group's riskiness (IFRS ja yrittyskaup... 2006, 33). In this approach assets need to be evaluated in certain groups, because otherwise there would be a huge number of different discount rates and it would be impossible to keep track of those. Hence, the method is mostly used for more widely known intangible assets such as technology, customer relationships, covenants not to compete or distribution channels (Olsen & Halliwell 2007, 67-68).

In addition to DCF Projection, Relief-from-Royalty approach is widely used. It is rather simple to use and provides highly credible results when applied correctly (Parr 2006, 4). The underlying idea is to calculate all the future royalties that are saved by owning the asset. Thus, this method is applicable to intangible assets such as patents, trade names and trademarks (Olsen & Halliwell 2007, 68). The correct using of Relief-from-Royalty needs five inputs, which are remaining life of patent protection, forecasted revenues, royalty rate, tax rate and discount rate (Parr 2006, 4).

Multi-period Excess Earnings method is not as simple as the two previous methods and not used that often. The idea is to separate the earnings that an intangible asset generates. However, the problem is that intangible assets rarely generate earnings without any tangible assets. Hence, we need to deduct the costs of using tangible assets from the earnings that the intangible asset generates. (Quilligan 2006, 11; IFRS ja yrittyskaup... 2006, 34.)

When applying the fourth alternative, Incremental Cash Flow method, the valuation is based on the cash flows of the owning entity. Those cash flows are compared to the cash flows of another entity that is identical but lacks the asset that subject to the valuation. The difference in cash flows is caused by the incremental effect that is brought by the asset. In practise it is problematic to find an entity that differs only in

one way. (IFRS ja yrityskaup... 2006, 36.)

### **2.5.3 Cost approach**

Cost approach may be used for valuation when market approach is not applicable. However, even in that case, it should be used alongside of income approach. A special case is impairment testing because there it is not allowed to use cost approach. On the other hand, it is reasonable as the idea of impairment testing is to recognise the fair value at the moment and not the historical value. (IFRS ja yrityskaup... 2006, 26-27.)

Assets are valued on the basis of their development or replacement cost. The method is particularly handy for internally developed assets whose development costs can be identified. Alternatively, the replacement cost is rather simple to calculate (Quilligan 2006, 11). However, this doesn't take into account the useful life of the asset. An example of an asset that can be valued with cost approach is software (IFRS ja yrityskaup... 2006, 27).

## **2.6 Comparison between IFRS and US GAAP**

The comparability of IFRS and US GAAP is an important question, because the two standards form a common background in academic research. Namely, many academics use both IFRS and US GAAP researches to form the theoretical background for their studies, but at the same time it is clear that the standards are not entirely the same. Hence, I take a look at the differences between the standards in the matters that are relevant in this thesis.

### **2.6.1 In general**

The International Accounting Standards Board has stated three objectives for IFRS. The first is to develop high quality standards, the second is to promote the use of them and the third is to bring about the convergence between different standards (Ball 2006, 8). In the comparison between IFRS and US GAAP, the objectives two and three are especially interesting. We can say that the promotion of the standards has been very successful, because IFRS regulation is applied in more than 100 countries worldwide (Use of IFRS... 2008). However, there is a significant exception. The USA is excluded from IFRS, because they apply their own US GAAP standards.

Common standards with the American companies would be very important for

Europeans and thereby the need for common accounting standards with USA is the second most important thing after the common standards within Europe. This turns the interest into the third objective of IASB, which is convergence of different standards. The direction of developments in IFRS has been mostly towards the American standards. In 2008 the convergence has reached such a deep level that in the USA foreign private issuers are even allowed to prepare their financial statements using IFRS without reconciling to US GAAP (Erchinger & Melcher 2007, 123).

The deep convergence has even led to outcome that in many situations, especially in academic papers, IFRS and US GAAP are treated as directly comparable standards (Lindahl & Schadewitz 2007, 2). A supporting argument for this point of view is the assumption of standards being close enough and thereby comparable to each other. On the other hand for example Lindahl & Schadewitz (2007) are arguing against that. They have examined differences in financial statements between IFRS and US GAAP. Their study had a sample of 42 companies that were listed in both EU and USA exchanges and they found clear differences in financials depending on the applied standards. Above all certain asset groups such as pensions, financial assets and goodwill were affected. However, a notable point is that the question what is close enough remains unsolved, because Lindahl and Schadewitz do not take sides in the matter of significant differences.

### **2.6.2 *In business combinations***

In the case of a business combination, the uniting of interests accounting became prohibited in the US GAAP as early as in 2001 (Massoud & Raiborn 2003, 26). Hence, for almost four years there was a significant difference between the accounting conventions that were applied in acquisitions in IFRS and US GAAP. In the beginning of 2005, the IASB amended its regulation concerning business combinations and it became very similar to that of US GAAP (Kimmitt 2004, 83). The uniting of interests accounting became prohibited and instead of that the only applicable method was the purchase accounting.

On the other hand, it is notable that IFRS became mandatory to apply in the EU from the beginning of 2005 and first from that point on most of the EU companies began to apply IFRS. In other words, the time that acquisition accounting was not aligned between IFRS and US GAAP, European and American companies were not even using comparable standards, because the Europeans applied their national standards before 2005. For most of the listed companies, the accounting for business combinations has been similar to US GAAP for the whole IFRS era.

When examining the accounting of business combinations in Europe from an

academic perspective, the problem is that the history of the legislation in this matter is only three years. Luckily for the theoretical evaluation, in the USA the purchase method have been mandatory already for seven years and the theoretical background has grown so that strong evidence about corporate management's behaviour in acquisitions under purchase method has been found.

### **3 EARNINGS MANAGEMENT**

#### **3.1 Defining earnings management**

It seems to be a difficult task to define earnings management. I have noticed this from numerous academic researches that begin by defining earnings management first based on the older definitions and carry on from that point to their own definition. This way the definitions of earnings management become many phrases long and are far from simple sentences.

It is easy to understand that basically earnings management is managing company's earnings, in other words that means what kind of a result a corporate wants to show to external parties. The problem is that when earnings management is divided into categories, we find categories that are very different from each other. Besides quite conservative earnings management such as management of discretionary accruals, there are very aggressive management opportunities such as earnings manipulation that refers to earnings management that is nearly against the accounting standards. A principal question is that can we talk about earnings management, if something is almost illegal.

This matter varies between definitions. One of the most well-known definitions is introduced in an article written by Healy and Wahlen (1999, 368). They state that "earnings management occur when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." This point of view includes to earnings management only misleading of some stakeholders, which means that earnings are not managed or manipulated so that well-informed investors wouldn't be able to see through the discretionary items that are used by the management.

On the other hand, Shipper (1989, 92) leaves more room for manipulative behaviour as he defines earnings management to be "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain." This aspect stresses the result of earnings management more than the managing of earnings, thus it also takes into account all the acts including manipulation that can be exercised in order to show a favourable result.

The most vast point of view taken to this matter is Giroux' (2004, 2) definition, because instead of defining earnings management as a whole, he divides earnings management into categories that are results from different accounting conventions. Based on the accounting conventions, he structures a continuum of accounting practises starting from the conservative accounting, which is very strict in rules. From this point

on the accounting becomes gradually more aggressive and finally fraudulent accounting can be identified in the other end of the continuum. I tend to support this view, because Giroux' definition describes very well the nature of earnings management. Earnings management is not meant to be recognised and thereby the best way to examine earnings management is through accounting practises. The alternative way is to examine the matter through accruals, but I choose the perspective of accounting conventions in this research, because it suit best to the selected research methods and target group.

## **3.2 The incidence of earnings management**

Earnings management has been a subject to study already for decades. Under this time the accounting standards have changed many times, nevertheless it still seems that the standards are not perfect in many ways and one thing proving that is the existence of earnings management. However, earnings management is a controversy issue, because it is well noticed in practise, but it has not been easy to prove in academic studies (Healy & Wahlen 1999, 370; Dechow & Skinner 2000, 236; Gore, Pope & Singh 2007, 123).

### **3.2.1 *The academic evidence***

In practise earnings management is noticed by different capital market participants. Among others, analysts' job is to make the needed corrections to the financial statements concerning discretionary accruals and other earnings management items to reveal the true economic state of the company. Many of the corrections are made to restore the changes that are made to show a better result. An additional support is given by the regulators of the capital markets, who identify regularly too aggressive earnings management that is against the set standards and thus is forced to intervene in the accounting practises of certain companies. (Dechow & Skinner 2000, 242.)

On the other hand, academics have had difficulties in identifying earnings management (Healy & Wahlen 1999, 368; Bao & Bao 2004, 1526). Dechow and Skinner (2000) have contemplated the underlying reasons that lead to the inconsistency between the practise and the theoretical framework. They separate three fundamental differences between academics and practitioners approaches. Firstly, academics are more into examining large data sets to find statistical significances. It seems that statistical definitions are not as powerful in identifying earnings management as observing actual cases in practise. Secondly, in the academic world, we have focused a lot on incentives that are based on contractual arrangement such as bonus plans or debt



covenants. It means that they are triggered by predetermined limits. Contrary to this practitioners concentrate more on incentives provided by capital markets such as analyst forecasts. In other words, it seems that earnings management is used more to meet the expectations on the capital markets than to avoid violating debt covenants. Thirdly, academics often rely heavily on the market efficiency. The argument is that capital market analysts should be able to clear the effects of earnings management. Hence, earnings management is meaningless and prices are generated on efficient markets. The efficient market hypothesis is difficult to prove right or wrong, but at least the regulators of the accounting standards are continuously fighting for more transparent financial information.

The views of Dechow and Skinner are in line with Healy and Wahlen (1999) and both papers support the stated views about the differences between practise and theory. Furthermore, Healy and Wahlen (1999, 380) concentrate on examining earnings management and stress that the most fertile ground for researching earnings management is through the capital market incentives and discretionary accruals instead of identifying total accruals from large data sets as it is done too often. This supports also the perspective of this study, because I am concentrating in particular on discretion in acquisitions in the part of empirical studies.

### ***3.2.2 The Finnish perspective***

Earnings management assumedly depends on many economic factors that might vary from a country to another. Not only the accounting standards set the frames in which companies manage earnings, but there are many other issues such as the structure of capital markets or the business culture. These varying factors motivate to analyse the earnings management issues also specifically from the Finnish point of view.

There are a few researches conducted by the Finnish researchers that concentrate on earnings management in Finland. These researches try to take into account the features of the Finnish capital markets. Junttila et al. (2005) pays a close attention to the causes deriving from the large role of telecommunication and electronics industries. On the other hand Kasanen et al. (1996) defines the Finnish market to be debt-dominated with concentrated ownership structure and taxation tied to reported earnings. All of these features are true on the Finnish market, although the implementation of IFRS has lowered the tax-orientation of financial reporting.

However, the results showing the existence of earnings management internationally are consistent in Finland as well. This has been proved in the studies that examine earnings management in Finland (e.g. Spohr 2004, Kallunki & Martikainen 2003, Kinnunen et al. 2000, Kasanen et al. 1996). Kasanen et al. (1996, 304) proved that

companies aim at smoothing dividend streams. This creates incentives to manage earnings upwards in case company needs more earnings to pay the predetermined dividend. On the other hand, there is an incentive to manage earnings downwards in case company has more earnings than needed to pay the dividend. Similar behaviour has been detected close to equity issues. Both, Spohr (2004, 170) and (Kinnunen et al. 2000, 226) found evidence that companies maximise earnings prior to equity issues in order to boost the share price.

The Finnish studies clearly proof the existence of earnings management in Finland. Moreover, the implementation of IFRS has taken us to the international field in accounting standards and earnings management as well. It means that international evidence is even more applicable to Finnish companies.

### **3.3 Incentives to manage earnings**

Of course, a fundamental question in studying earnings management is that why it exists? It would be easier to detect earnings management in case we first find out the underlying managerial motives. Unfortunately, it seems to be impossible because suggested theories have not been able to fully explain earnings management. However, it is essential to be familiar with the theories because they provide good insights concerning earnings management and they help in recognising earnings management actions ex-post.

#### **3.3.1 *Capital market based incentives***

Financial reports have a strong impact on the value of companies' shares and that creates an incentive for managers to manage financial figures in order to show positive prospects (Healy & Wahlen 1999, 370). The goal is to achieve a positive mood by meeting analysts' forecasts, which again require companies to report steady earnings growth that does not disappoint market expectations (Bens et al. 2003, 53).

The benefit that high performance companies get is analysts' favourable attitude towards the share. Good news boost management's credibility and also company's share price is likely to rise. (Bartov et al 2002, 174.) This result that earnings management through positive surprises could raise share prices has received support from Kasznik and McNichols (2002, 730). They find that better companies that meet and beat the forecasts have higher relative share price compared to companies that do not meet analysts' forecasts. It seems that companies can create value out of nowhere. More support to the statement is received by Myers et al. (2007, 249). They find the

same premium in the share price caused by earnings management but in addition they observe that the premium is likely to disappear when the company fails to meet the analysts' forecasts. In other words the premium is temporary, but undoubtedly creates a strong motive for managers. Although the premium would only be temporary in the end, it can last for several years because companies report financial statements only four times a year.

### **3.3.2 *Managers' compensation based incentives***

It is often argued that the only incentive that gets managers to do their jobs as well as they can is to give them good compensation schemes that are aligned with owners interests. There are results that support this point of view (e.g. Healy 1985, Holthausen et al. 1995, Guidry et al. 1998). It is considerable that in these researches the result has been that managers defer income when their bonuses for the current period are full. This way they are able to get a good start for the next period.

From investor's point of view, earnings management that defer income is not terribly harmful when compared to earnings management that aims at showing better financial figures than in actual fact. The evidence of managing earnings upward is not as robust as the evidence concerning deferring income. However, it is found that in certain occasions managers use earnings management more often than otherwise. In those situations earnings management is usually also effective. An example could be IPOs when managers try to impress investors in order to receive higher price per share (Spohr 2004, 157).

On the other hand managers' compensations can be viewed from another direction. In particular, when economy is not growing and companies have tougher times, managers aim more at just keeping their position and it can be considered that managers have to perform well all the time or they get fired from their job. Fudenberg and Tirole (1995, 75) have shown that managers smooth earnings to achieve a smooth growth that hopefully is enough for the owners of the company and secures their job.

## **3.4 The methods of earnings management**

The financial situation of the company affects naturally on the objective of earnings management. Depending on the objective, I have divided earnings management into three separate courses of action, which are income increasing or decreasing, income smoothing and big bath.

### **3.4.1 *Income increasing or decreasing***

The most common action in earnings management is the increasing or decreasing of the current period's earnings (Nelson et al. 2003, 21-22). Thus, it can be the method to achieve either the predetermined earnings target or the objective can be just to show better or worse result than with the current accounting convention.

I provide a few examples in order to enlighten earnings management goes and is examined in practise. Firstly, in the academic literature, earnings management is most often examined through accruals and especially though total accruals. Accruals in general means accounts that include items that are most likely to generate a future cash flow and thus need to be taken into financial reporting figures (Leppiniemi & Leppiniemi 1997, 70). Examples are accounts payable and receivable, future payable interests, future tax liability and loan loss provisions (Beatty et al. 2002, 553). The use of accruals is mandatory, but the valuation of these accounts often includes consideration, which enable earnings management. In the academic research the most used measure of accruals is the total accruals that are defined to be the difference between the earnings from continuing operations and the cash flows from continuing operations. In case the difference between these numbers varies from an accounting period to another, most likely it is a result from earnings management. (Kaszniak 1999, 63.) An important point to notice is that total accruals are not undisputedly true in every case. Only a part of total accruals contain possibilities to managerial consideration. That is why it would be more correct to observe only discretionary accruals. However, total accruals' popularity can be explained by its simplicity, because it is a difference between companies' earnings and cash flows, and on the other hand, total accruals uncover the total monetary amount that the company has outstanding.

Secondly, earnings management can also be examined through operational activities that have direct cash flow effects. Evidence is provided by Roychowdhury (2006, 364), who finds out that managers are more likely to manipulate real activities in case it offers a possibility to meet the earnings expectations. Aligned with this Bens et al. (2003, 54) found that managers try to amend the dilutive effect of employee stock options by stock repurchases and taking the money from R&D expenses. In addition, Beatty et al. (2002, 553) discovered that financial institutions manage earnings through operational activities by realising more or less security gains or losses. All the mentioned actions have direct cash flow effects to the company accounts and can be categorised to be effective earnings management. On the other hand, it is important to understand that operative earnings management is likely to be more costly for the company than accruals based earnings management (Roychowdhury 2006, 338).

### **3.4.2 Income smoothing**

Investors in the capital markets do not like surprises and that it is why predictable earnings and dividends are generally very welcomed from the market's perspective. Because the markets are waiting for a certain relative income from the current period compared to the previous period, it is very well known that companies smooth earnings around the pre-determined targets to keep the trend going on (DeFond & Park 1997, 115).

The incentives for this behaviour were first introduced by Gordon (1964, 261-262). He states that income smoothing is rational based on three assumptions. Firstly, managers maximise their utility. Secondly, managerial utility depends on firm value and shareholder satisfaction. And thirdly, shareholder satisfaction and share price rises with earnings growth and stability.

Gordon (1964) assumed the market to be ineffective, but in 1978 Watts and Zimmermann introduced the positive accounting theory that assumed the market to be effective. In other words that made earnings management useless because the markets could see through it and restore the changes in the financial information. Nevertheless, supporting results for income smoothing were found in academic researches. Moses (1987, 374) found out that the political costs' hypothesis from the positive accounting theory explains income smoothing. Moreover, some evidence was also subsidising the rationality of income smoothing in management's bonus plans.

Another important point to notice in the discussion of market efficiency's effects to earnings management is that ultimately it is the beliefs of managers that decide the utilisation of earnings management (DeFond & Park 1997, 391).

### **3.4.3 Big bath**

A term "big bath" is used in earnings management literature to describe large write-offs and restructuring costs that are claimed to aim at under-reporting earnings in the current period. The underlying idea is that when managers realise they won't meet the level of earnings that is set as their goal, they can as well fall much short from the goal. In practise, this means that they are eager to take large write-downs or restructuring costs in the current accounting period although it wouldn't be mandatory. This ensures that there are no negative surprises in the near future. (Kirschenheiter & Melumad 2002, 762; Christensen et al. 2008, 602.)

The big bath phenomenon is limitedly covered in the field of accounting research and there is no clear theoretical framework for the managerial incentives (Kirschenheiter & Melumad 2002, 762). However, there are results showing that companies rarely miss

the set earnings targets by small margins (Dechow et al 2003, 355; Roychowdhury 2006, 337). Hence, when a company is likely to fall short from its target, a one-off expense is more likely to take place.

The motivation of big baths can be explained by managers' bonus hypothesis as well as by capital market incentives. However, this has been more difficult to prove and it is not clear that is it enough strong incentive for managers (Healy 1985, 31; Guidry et al. 1998, 113; Healy 1999, 147).

Finally, Masters-Stout et al. (2007) have found that new managers are more likely to make large write-offs than their senior counterparts. The reason is that new managers can put the blame of large expenses on the former manager. This result is in line with Fudenberg and Tirole's (1995, 91) result that managers engage in earnings management because that is essential for them to keep their jobs.

### **3.5 Earnings management examples**

When purchase price allocation is examined from earnings management's point of view, the objective is naturally to carry out the allocation in a way that is most favourable for the business combination. To succeed in this, the company needs to take into account the accounting treatment for the following years and possible sudden changes in asset values.

A buying company pays a certain price to acquire another company and with the paid price it receives certain assets that have exact book values. These factors can be taken as given when examining acquisitions from earnings management's perspective. The next step in purchase price allocation is to plan the revaluation of the acquired assets. At this point it is possible for the acquirer to apply consideration in order to manage future earnings. Because most likely there is a gap between purchase price and recognised assets in the first place, the buyer tries to fill in the gap by identifying and valuing intangible assets (see Figure 2, p. 19). There is a lot of discretion in valuing intangibles and that is why there is a good chance to turn the accounting figures more favourable for the company. (Sinnott 2002, 49.)

#### ***3.5.1 The roles of goodwill and indefinite useful lives***

In general, the acquiring company makes a decision that does it want to allocate a lot of purchase price to assets that have finite useful lives or to goodwill and assets that have indefinite useful lives. The principal difference is that assets having finite useful lives are depreciated within the useful life. Contrary to this, goodwill and assets with

indefinite useful lives are not depreciated, but are subjects to impairment testing.

For instance a company may want to use aggressive allocation to assets that will be depreciated and thereby reduce the amount allocated to goodwill and assets that are not depreciated (Table 1, case A). On the other hand the company may want to allocate purchase price aggressively to goodwill and assets that have indefinite useful lives (Table 1, case B). Hence, less purchase price goes to depreciable assets compared to case A. The following Table 1 illustrates the comparison.

Table 1 Example of the effects of goodwill

<i>Case A</i>						
Year	1	2	3	4	5	6 ...
Depreciable assets	10 000 000	9 000 000	8 000 000	7 000 000	6 000 000	5 000 000
Depreciation 10 % per year	1 000 000	1 000 000	1 000 000	1 000 000	1 000 000	1 000 000
Goodwill	5 000 000	5 000 000	5 000 000	5 000 000	5 000 000	5 000 000
Contingent impairment	0	0	0	0	0	0
<b><i>Earnings effect</i></b>	<b>-1 000 000</b>	<b>-1 000 000</b>	<b>-1 000 000</b>	<b>-1 000 000</b>	<b>-1 000 000</b>	<b>-1 000 000</b>
<i>Case B</i>						
Year	1	2	3	4	5	6 ...
Depreciable assets	5 000 000	4 500 000	4 000 000	3 500 000	3 000 000	2 500 000
Depreciation 10 % per year	500 000	500 000	500 000	500 000	500 000	500 000
Goodwill	10 000 000	10 000 000	10 000 000	10 000 000	5 000 000	5 000 000
Contingent impairment	0	0	0	<b>5 000 000</b>	0	0
<b><i>Earnings effect</i></b>	<b>-500 000</b>	<b>-500 000</b>	<b>-500 000</b>	<b>-5 500 000</b>	<b>-500 000</b>	<b>-500 000</b>
<b><i>Case A vs. Case B</i></b>	<b>-500 000</b>	<b>-500 000</b>	<b>-500 000</b>	<b>4 500 000</b>	<b>-500 000</b>	<b>-500 000</b>

We see that increasing goodwill or amount of assets with indefinite useful lives result higher reported earnings in the near future, but create a time bomb that is likely to occur in some future year. In the example it is year 4, when the effect of the acquisition is heavily negative and assumedly affects negatively the share price at the time. (Nelson et al. 2003, 30.) On the other hand by choosing small depreciations (case B), the management can artificially boost its earnings in the near future compared to case A, although it would foresee that a goodwill write-down is coming. By boosting earnings, the management may for example achieve longer strings of positive earnings surprises.

### ***3.5.2 Consideration in depreciations of intangible assets***

To become even more complicated, the management is able to use discretion also in the depreciations of assets. The discretion may be used in both tangible and intangible assets. However, the value of tangible assets can usually be identified more reliably and thereby little consideration can be used. Contrary to this, the fair values of intangible assets are more complex to estimate.

It is obvious that the value allocated to intangible assets is depreciated within its useful life in case the useful life is possible to define. An additional claim is that the depreciations should describe the real deductions in the values of assets. (Spillane 2005, 26.) This demand is in line with the idea of fair value accounting. However, by choosing an aggressive valuation method instead of a conservative valuation method companies can manage the future depreciations irrespective of the amount allocated to goodwill.

An example case is shown in Table 2. A company has an intangible asset that is estimated to generate a yearly income of 2 million. The company plans to depreciate the asset in 15 years, because it has been a common practise in the company for this kind of assets. Moreover, I assume the rate of discount to be 5 % p.a. In the following table case A demonstrates a conservative accounting method and cases B and C demonstrate a more aggressive accounting method.



Table 2 Example of the effects of different depreciation plans

<i>Case A</i>	NPV	20 760 000					
Year	1	2	3	4	5	6 ...	
Balance sheet value	20 760 000	19 376 000	17 992 000	16 608 000	15 224 000	13 840 000	
Depreciation	1 384 000	1 384 000	1 384 000	1 384 000	1 384 000	1 384 000	
<i>Earnings effect</i>	<b>-1 384 000</b>	<b>-1 384 000</b>	<b>-1 384 000</b>	<b>-1 384 000</b>	<b>-1 384 000</b>	<b>-1 384 000</b>	

<i>Case B</i>	NPV	40 000 000					
Year	1	2	3	4	5	6 ...	
Balance sheet value	40 000 000	37 333 333	34 666 667	32 000 000	29 333 333	26 666 667	
Depreciation	2 666 667	2 666 667	2 666 667	2 666 667	2 666 667	2 666 667	
<i>Earnings effect</i>	<b>-2 666 667</b>	<b>-2 666 667</b>	<b>-2 666 667</b>	<b>-2 666 667</b>	<b>-2 666 667</b>	<b>-2 666 667</b>	

<i>Case C</i>	NPV	20 760 000					
Year	1	2	3	4	5	6 ...	
Balance sheet value	20 760 000	16 760 000	13 760 000	11 260 000	9 260 000	7 760 000	
Depreciation	4 000 000	3 000 000	2 500 000	2 000 000	1 500 000	1 000 000	
<i>Earnings effect</i>	<b>-4 000 000</b>	<b>-3 000 000</b>	<b>-2 500 000</b>	<b>-2 000 000</b>	<b>-1 500 000</b>	<b>-1 000 000</b>	

In case A, there is a conservative approach to valuation, where I have calculated the net present value based on the income of 2 million per year for 15 years, which is the useful life. In turn in case B a higher net present value is reached, because it is calculated based on an assumption that the 2 million a year income goes to entity. Nevertheless, the whole value of the asset is depreciated in 15 years. This results bigger depreciations than the conservative valuation, but enables the company to allocate more purchase price to identifiable assets, which again deducts the amount of goodwill.

When cases A and C are compared, we see that the NPV is the same, but in the case C we have bigger depreciations. In case C, company's management has considered that the value of the asset falls quickly in the beginning and thereby also the depreciations need to be big in the beginning. An example of this kind of an asset could be customer relationships that are often vital in the beginning of a newly acquired business, but lose importance later on as new customer relationships are bound.

## **3.6 Earnings forecasts**

### ***3.6.1 The importance of analysts' forecasts***

Analysts' forecasts play a key role in earnings announcements because reported earnings are compared to the collected consensus forecast that is the average of all forecasts. This often predetermines the direction of movements in company's share price (Burgstahler & Eames 2006, 633). An ideal situation from capital market's point of view would be that the realised earnings would meet the forecasted earnings precisely. In order to promote this goal companies give their prospects concerning the future in advance. Some companies have even extended this to a level, where they forecast their future earnings themselves.

The objective is to diminish the share price volatility near earnings announcements, because especially small negative surprises are likely to be repeated in the share price (Kinney et al. 2002, 1297). The managing of price fluctuations is proven to be difficult and thereby many companies have lessened announced information. An example is Nokia that used to give earnings forecasts itself, but has subsequently given up the convention (Koskinen 2008).

However, it seems that companies have certainly a good understanding concerning analyst forecasts, because based on many studies there is an unusually low frequency of small negative earnings surprises and an unusually high frequency of zero or small positive earnings surprises (e.g. Dechow et al. 2003, 355; Burgstahler & Eames 2006, 635).

This all proves analyst forecasts to be an issue that has a significant effect on companies' share price and that way also to businesses and credibility of a company. On the other hand it means that earnings management is a very relevant matter and needs to take into consideration in every publicly held company.

### ***3.6.2 Analysts' work***

The work of an analyst is to value shares based on the estimates that are given. Theoretically the value of a share is only dependent on the dividends it pays out (Penman 1999, 107). This means that it would be possible to define a share price directly by discounting future dividends. However, practise has shown us that it is not possible to assess dividends reliably to eternity. Because of this, we need to value shares also by other methods (Jiang & Lee 2005, 1466).

The most common alternative methods are discounted cash flows and residual earnings model (Kallunki et al 1999, 82). The objective of these methods as well as the dividend discount model is to discover shares that are traded under the theoretical value given by a valuation model. By following the logic, this would mean that sooner or later also the market would recognise the correct price and the share would be traded in the price coming from a valuation model. However, we need to remember that ultimately there is only one correct share price at the moment and that is the market price. Every other price is more or less speculative and thereby there is room also for pricing through multiples. Multiples refer to all kinds of ratios such as market price per earnings (P/E) and market price per book value (P/B) (Kallunki & Niemelä 2004, 65).

### 3.6.2.1 *Discounted dividends model*

The dividend discount model is the fundamental model of all share valuation models (Kallunki et al. 1999, 82; Penman 1999, 107). When we consider the value of a share from investor's perspective, we have three cash flows. Firstly, we buy a share, which generates a negative cash flow. Secondly, we receive dividends, which are positive cash flows. And finally we sell the share and receive a positive cash flow. On the capital market, buys and sells between investors overrule each other and therefore the value of a share is simply the discounted dividends as shown in the figure.

Figure 3 Dividend discount model (Kallunki & Niemelä 2004, 103)

$$P_0 = \frac{D_1}{1+r} + \frac{D_2}{(1+r)^2} + \frac{D_3}{(1+r)^3} + \frac{D_4}{(1+r)^4} + \dots$$

We see that the model is very simple and reasonable. All the dividends are discounted by the investors' rate of return. Another way to look at the matter is to compare a share to a bond and the valuation becomes even simpler. For a bond we always know an exact value, because the coupon rates are certain income. For a share the certain income is dividends, but we need to estimate their amount. Hence, as new information is released, the estimate changes and the share price moves.

On the other hand, the model has been roughly criticised. Penman (1999, 111) points out that at least in the short run dividend payout is not related to share value, which is also supported by Jiang and Lee (2005, 1466). Ohlson (1995, 663) brings up in his paper more fundamental questions such as the assumption of the risk neutrality in the model. In other words he means that every investor has to have objective beliefs about

the future and in reality this is not likely to be the situation.

### 3.6.2.2 *Discounted cash flow models*

The discounted cash flow models have the same strong point as the dividend model. They both concentrate on actual cash flows and thereby the accounting discretionary should not affect them (Kallunki et al. 1999, 86). This point is very important later in the empirical part of my study, when I examine the effects of earnings management on share valuation.

The most common discounted cash flow model is the free cash flow model. The idea is to calculate the free cash flows (FCF) that are the cash flows to investors. In the model it means that the value of equity is calculated as the difference between the value of the invested capital and the financial debt (Skogsvik 2002, 15).

Figure 4 Free cash flow -method (Kallunki & Niemelä 2004, 109)

$$P_0 = \frac{FCF_1}{1+r_e} + \frac{FCF_2}{(1+r_e)^2} + \frac{FCF_3}{(1+r_e)^3} + \dots$$

As we see from the figure, by recognising the cash flows and discounting them by the cost of capital we find out the operations that generate more revenue than the initial investment to the operations. Thus, the advantage of the model is the possibility to look at the underlying factors of future growth (Kallunki et al. 1999, 86).

In many ways free cash flow model is a very good model in valuing shares and it is also very popular. It is much more sophisticated and versatile than the dividend discount model. Nevertheless, it faces many of the same problems. Free cash flows do not measure the added value in the short run. Neither does it take into account the value that is added otherwise than through cash flow operations. Thirdly, it needs long time horizons because an investment is always a cash payout and the subsequent positive cash flows need to be calculated far to the future. (Penman 1999, 117.)

### 3.6.2.3 *Residual earnings model*

In simplicity the weakness of the previous models was that they cannot bind the accounting data into a share value (Jiang & Lee 2005, 1467). The residual earnings model does that, because it is accounting data based. The model is based on the

dividend discount model, but the dividends are replaced by company's earnings.

Figure 5 Residual earnings model (Kallunki & Niemelä 2004, 119)

$$P_0 = BV_0 + \frac{ae_1}{1+r} + \frac{ae_2}{(1+r)^2} + \frac{ae_3}{(1+r)^3} + \frac{ae_4}{(1+r)^4} + \dots$$

Share prices in the model include the book value of equity and residual earnings are added on it. The demanded rate of return by investors is used as the discount rate of the cash flows. This way residual earnings measure the amount of earnings that is produced on top of investor demands'. It is notable that the book value included in the model relies that the book value is the correct value for the underlying business. Because it might not always be the best estimate to describe the true potential of the company to generate earnings, the residual earnings model is often considered as too liable for earnings management that is based on discretion in accounting procedures. (Kallunki et al. 1999, 96.) However, if the accounting data is correct, the model should work better than previous models, because its outcome does not depend as much on the discount rate and the capital structure of the company (Kallunki & Niemelä 2004, 121).

#### **3.6.2.4 Multiples**

There are an infinite number of multiples, because a multiple is always a relation between two accounting measures. Thus, it is possible to create a new multiple by comparing two numbers.

The problem with multiples is that they do not give any monetary values and it would be impossible give a value to a share unless there is a comparable monetary value. On the other hand, multiples are handy and revealing in speculative situations, where for example market sentiment is likely to exaggerate share prices. The general valuation level can be revealed by comparing present multiple to their historical values. With multiples share values can also be compared to industry averages and the valuation level of a company in comparison to its rivals is quickly recognised.

#### **3.6.3 The used methods and accuracy of forecasting**

The fundamental questions in the academic researches concentrating on analyst forecasting appears to concentrate on the methods that analysts are using in share

valuation and on the other hand study the accuracy of analysts' recommendations and forecasts. The results of various researches have not been able to identify any valuation method that would be better than the other methods (Bradshaw 2004, 26). Theoretically, as the academic literature in this field widely suggests, the view that different present value models such as the presented discounted dividend model, discounted cash flow model and residual earnings model are the best and most suitable to predict the future value of a company (e.g. Block 1999, 92; Ohlson 1995; 681). However, this is not the case in practice. Although present value models are widely used, the models have also clear disadvantages and thereby methods that use timelier market information and take into account the sentiment on the capital market are used as well. An example of these methods is the use of multiples in valuation. Moreover, analysts do not feel that they are able to see enough accurately many years forward. They recognize that uncertainty in the present value models rises as forecasts go further into the future. This is likely to alter share prices quickly when the market conditions change. (Block 1999, 92.)

The result that analysts do not blindly use present value models is motivated by the point that share prices do not necessary meet their intrinsic value because of market conditions (Bradshaw 2004, 29). The work that analysts put on the forecasting of share prices should increase value already based on the matter that the use of analysts is a cost for the receiver of the information. Thereby it is assumable that there are results reporting analysts to equal or exceed the outcomes of individual models. (Schipper 1991, 1079.) From this perspective it is not surprising that the matter seems to be so. However, researchers have also found opposite results. For example Bradshaw (2004, 25) reports a result that buy-and-hold investors have received higher earnings by following present value models that aim at revealing the intrinsic value of a company, rather than following analyst recommendations. This in turn is in line with the prevailing academic perspective. However, it seems that analysts take the market conditions better into account.

#### **3.6.4 Forecast guidance**

I have shown that managers may exploit earnings management in order to achieve pre-determined earnings goals. This is the common form of earnings management. However, a related topic in the field is managers' forecast guidance. It means that managers approach the problem of meeting the earnings forecasts from the other end of the equation, namely managing the earnings expectations. They guide analysts so that they expect more modest levels of earnings. (Brown & Higgins 2005, 281.)

The academic evidence is not as robust for forecast guidance as it is for classical earnings management. One reason might be that forecast guidance is more difficult to

detect than direct earnings management. Nevertheless, when Matsumoto (2002) compares earnings forecasts between companies that meet the goals and companies that do not, she receives supporting evidence. In the research, she compares two earnings forecasts in the company level. Firstly, she creates her own earnings forecast based on historical earnings. Then she compares this to analysts' consensus forecast. The result is that analysts' consensus forecast is relatively lower for companies that meet the earnings forecasts. In other words the result is saying that the companies, which meet the set forecasts, have also guided forecasts.

Supporting evidence is found by Bartov et al. (2002), who examined forecast guidance from another perspective. They compared forecasts that were issued near earnings announcements to forecasts that were issued much before earnings announcements. The outcome was that the forecasts issued later were more likely met by companies. It is clear that companies have more precise earnings estimates nearer announcement dates and thereby only the deviation of estimation errors should be smaller compared to earlier estimates. Instead of this, companies beat the forecasts more often which reveals their forecast guidance.

## **4 EMPIRICAL STUDIES**

This section introduces the results of my study. I have divided the content into chapters based on the perspective they take to the research questions. Chapter 4.1 provides results about analysts' level of knowledge and attitude concerning IFRS and reporting of acquisitions. Chapter 4.2 seizes in detail to decisions that are made in allocation reports. Chapters 4.3 and 4.4 concentrate on analysts' beliefs and actions.

### **4.1 Knowledge of reporting standards**

The changes in the applied accounting standards under the past few years motivated me on its part to carry out this research. That was also my starting point, when I began analysing reporting of acquisitions. In my opinion, it seemed relevant and important to map also analysts' knowledge about the standards, because the standards are in a key role in reporting of acquisitions. Moreover, a matter that I think could be closely related to respondent's level of knowledge is the quantity of acquisitions and divestures in the companies that the respondents follow. Hence, I asked how well the analysts know IFRS 3 Business Combinations in order to map the knowledge of the standards regulating acquisitions. And to cover the second point, I asked about the quantity of corporate acquisitions and divestures in the companies that the respondents follow.

The result is that a majority of 68 percent consider they know IFRS 3 well enough for their job. Only one respondent out of the whole sample of 25 considered that he knows IFRS 3 very well and as high percentage as 28 admitted that they know IFRS 3 badly. On the other hand, four out of five respondents thought the companies they analyse do acquisitions and divestures as much as an average company. 12 percent considered their companies do more transactions than on average and 8 percent considered their companies do less transactions than an average company.

It would be reasonable to find a consistency between the answers to the previous questions, because in case an analyst's companies do many acquisitions, you could also think that he has a good understanding of IFRS 3. However, this is not the case. I cross-tabled the answers in every relation, but I did not find consistencies between the two matters.

The interviews gave about the same result as the survey. All the interviewees think that they know IFRS well enough. They have got some education concerning IFRS, but the standards are in a secondary role in the job of an analyst. However, in case analysts need more information about the standards, they try to find it independently. A very interesting matter that came up concerning financial reporting is that none of the interviewees would ask for additional information from the reporting company, even



though the information should be announced according to IFRS. On the other hand the interviewees say that they notice in case there is new information announced in financial reports that is not announced in the previous reports. Additional information is in most of the cases also considered as a good sign from analysts' perspective.

Especially interviewee 4 has very international companies to analyse. Hence, I found it interesting to ask him that how he sees the difference between IFRS and US GAAP. According to his experience, there is no difference between the two standards in share valuation, because after all analysts follow only the core business of a company. Thus, the accounting procedures that are anyway close to each other, do not make the difference.

After the short part concentrating on background information in the beginning of the survey, the following question I had in mind was that how important is the information about acquisitions that is given during the financial year. And in addition, how useful is the acquisition and allocation report quoted in the notes of financial statements.

I gave alternatives to ease and expedite the answering to questions. I structured five categories. The aim was that the middle alternative reflects a neutral attitude towards the stated question. Two alternatives reflect to a more positive attitude and two alternatives reflect to a more negative attitude. Positive and negative alternatives are mirror images to each other. This kind of categorical answering system is very common in surveys and it is also applied in most of the question in this research. The categories are applied in the distributions of the answers that are shown in the figures 2 and 3.

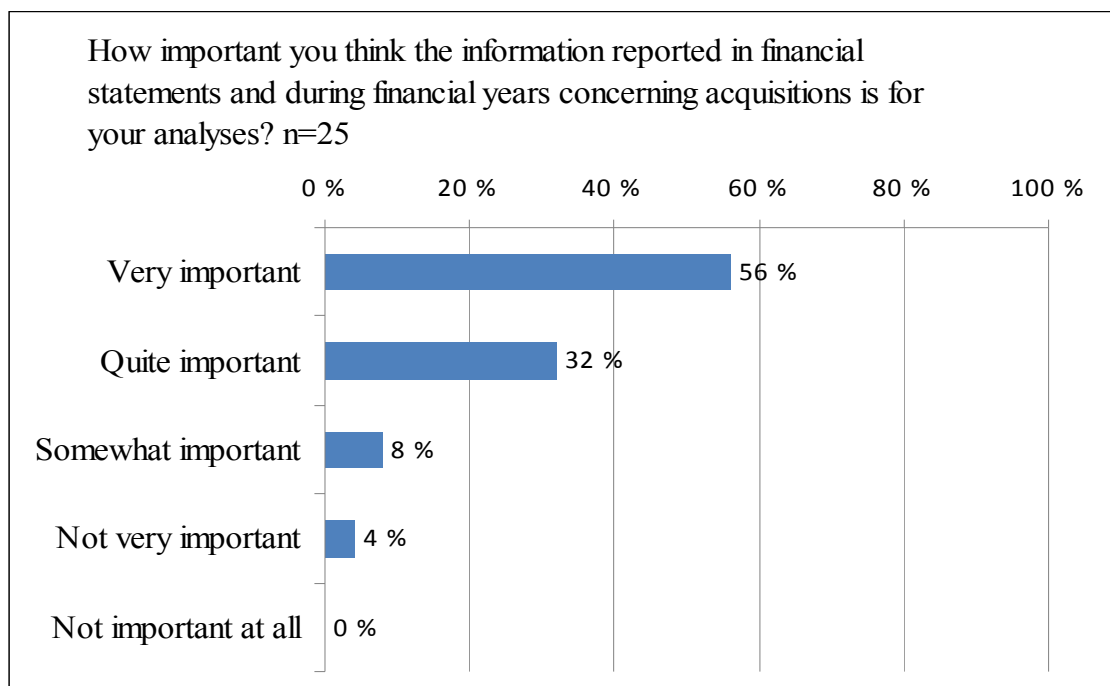


Figure 6 Meaning of the information about acquisitions

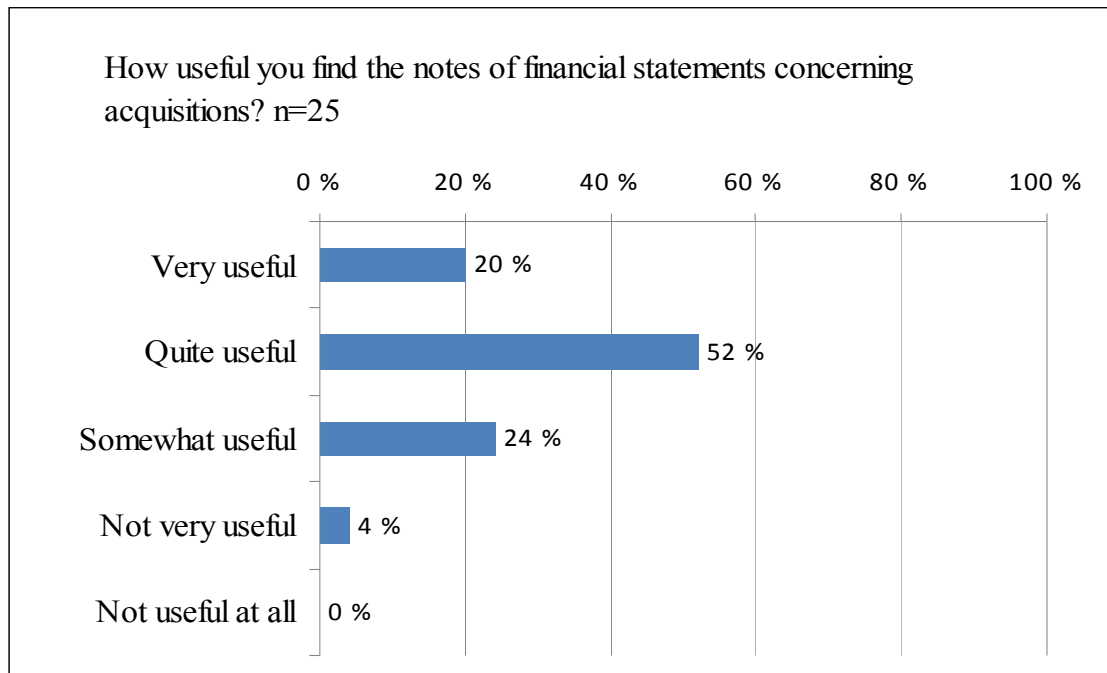


Figure 7 Meaning of the information in purchase price allocation report

By comparing the two figures, we see the differences between assumedly relative matters. The figure 2 reveals that altogether 88 percent, in groups of 56 percent and 32 percent of respondents find reported information about acquisitions very important and quite important, respectively. However, the importance of acquisition and allocation information in the notes of financial statements is not as high as the importance of all the available information, because only 72 percent find the notes section quite or very important.

A likely explanation for this difference came up in the interviews, in which the interviews tended to think that reporting of acquisitions is very important, but the notes section is not always as important. This is because the notes section does not cover acquisitions enough comprehensively and in many cases analysts try to dig information from other sources as well.

The result that the reported acquisition information in aggregate is more important for analysts than the information in financial statements alone motivates me to pose a question that from where the respondents find the information that makes the difference. The question is that do you find or receive information concerning the allocation of purchase price from other sources besides the notes of financial statements. The survey result was that 36 percent looked for additional information and 64 percent did not. A notable relation recognised through cross-tabling was that the respondents, who looked for additional information also kept the information about acquisitions more important than an average respondent. Almost 90 percent (88,8 %) of the respondents looking for

additional information concerning acquisitions found the information very important, while in the whole sample the same number was 56 percent (refers to Figure 6).

The same difference did not exist when the analysts looking for additional information were cross-tabled in relation to the answers in the question about acquisition and allocation reports in the financial statements (refers to Figure 7). In other words, the analysts that look for information from other sources are likely to keep acquisition reporting very important, but they do not think that purchase price allocation report in the notes of financial reports is more important than it is for an average analyst. All in all, this means that the difference in importance of acquisition reporting between analysts comes from other sources than from the announced information that is regulated by IFRS.

Hence, in case the difference is not deriving from mandatory reporting requirements, it has to come from voluntary reporting. That is why I asked the respondents who look for additional information besides financial statements a follow-up question about the primary source of additional information. In the answers two main sources came up. Firstly, the top management of the acquirer gives more information in many cases, which also makes sense from earnings management's point of view. This might namely also be related to forecast and expectations management in some extent. Secondly, the analysts are likely to look for the information from the other end referring in this context to the company that is bought. Their financial statements provide additional information that can be compared to the figures of the business combination. In many cases the bought company is private before the acquisition and the financial information is not public. In the cases analysts try to find information from the National Board of Patents and Registration of Finland.

## **4.2 Meaning and consequences of allocation decisions**

The significance of acquisition reporting is proven by the results of the previous section. This provides me a solid background to move on to examine the content of purchase price allocation reports. In my examination, I use five subdivisions to cover the information content of the reports. Three of the subdivisions are concentrating directly on price allocation. The first is purchase price allocated to tangible assets, the second is price allocated to intangible assets and the third is price allocated to goodwill. In addition to these I separated information concerning useful lives of assets into a subdivision, because it is an essential issue concerning valuation models. Finally, the fifth subdivision is future prospects concerning the acquired business. I continued to use categorical alternatives as I had done in the previous questions as well. However, this time the distribution looks a bit different and forms a table instead of a figure, because I

have all the subdivision under the same question.

**Table 3 Importance of asset classes in reporting of acquisitions**

How important is the reporting of the following information concerning acquired businesses? n=25

	Very important; value=1	Quite important; value=2	Somewhat important; value=3	Not very important; value=4	Not at all important; value=5
Purchase price allocated to <i>tangible assets</i> ; mean=2,52	20 %	32 %	24 %	24 %	0 %
Purchase price allocated to <i>intangible assets</i> ; mean=2,44	20 %	40 %	16 %	24 %	0 %
Purchase price allocated to <i>goodwill</i> ; mean=1,96	36 %	40 %	16 %	8 %	0 %
<i>Useful lives</i> of the most important assets; mean=2,48	20 %	36 %	20 %	24 %	0 %
<i>Prospect</i> concerning the acquired business; mean=1,36	76 %	16 %	4 %	4 %	0 %

On the basis of the mean values of the scaled answers, we notice that the information concerning future prospects of the acquired business seems to be the most important individual issue in the acquisition reports (a mean value of 1,36). As clear as this is also the second most important thing that is the allocated amount of purchase price to goodwill (a mean value of 1,96). The rest of the alternatives seem to be equally important, because their mean values are within one decimal (about 2,5).

My study concentrates on exploiting of discretion in accounting procedures in acquisitions and from this perspective Table 3 reveals an interesting perspective that needs to be taken into account in the context of this thesis. The most important individual issue in acquisitions' reporting is prospects concerning the acquired business at least in this sample. The result might give the impression that accounting procedures

do not play such an important role in reporting, because business prospects have nothing to do with discretionary accounting, although business prospects are otherwise subjects to discretion. I want to point out that all the other options concentrate on discretionary accounting and at least their sum effect should be notable in proportion to business prospects, although in this setting the relation is impossible to measure. Moreover, I refer to the meaning of the question that is not to put accounting information and non-accounting information vis-à-vis. The meaning is to find single important factors in company reporting and that is why I have divided the matters of discretionary accounting into four classes. Anyway, a conclusion that can be made is that there are also other relevant issues in acquisitions' reporting in addition to accounting procedures.

Further from the general perspective the answers reveal that none of the respondents found any of the classes to be not at all important and more than 80 percent of the respondents considered the matters at least somewhat important (the categories not at all important and not very important comprise a sum of 21 answers out of 125 answers totally, see Table 3). All in all, I can say that every subdivision is followed, although goodwill is the most important single issue.

From the accounting perspective the importance of goodwill is to some extent paradoxical. We know that asset values and the amount of goodwill are substitutes to each other, because the allocated amount i.e. purchase price is definite in the beginning of purchase price allocation process. It means that in case something is taken off from goodwill it has to be put into tangible or intangible assets. Why then goodwill is more important than either of the assets classes? Firstly, this might possibly be explained by a variation of industries in the sample. For example in the IT sector intangible assets are very important and on the other hand tangible assets are not significant. In contrary, for example construction business puts more weight on tangible assets and intangible assets are in a smaller role. Nevertheless goodwill is important in both industries. Hence, it is possible that in my sample, which includes many sectors, goodwill is always important, but the importance of intangibles and tangibles varies from industry sector to another. I discussed this topic especially with the interviewee 3.

Alternatively, it is possible that goodwill is simply more significant from analyst's perspective. This option seems more likely on the basis of the cross-tabling I did for answers in this question. Majority of the respondents chose the same alternative in both classes, i.e. in tangible assets and in intangible assets. Moreover, I discussed in particular the significance of goodwill in the interviews. The result is unambiguous. All the interviewees considered that goodwill has a stock market dimension and the asset classes do not have that. Goodwill is a subject to impairment testing and thereby to write-downs, which creates the incentive to investigate it more precise. A write-down is according to the interviewees always a negative sign to stock markets. Goodwill also

entails unidentified things, such as synergies. In case of a write-down, it means that a company has not been able to convert the unidentified things to asset values and incomes.

So far the results are saying it is clear that analysts pay attention also to single asset classes and not just to allocation reports as a whole. In this context I find it significant to ask also about the effects of allocation decisions. When a company announce an acquisition, it is instantaneously analysed on the basis of the forecast given by the company itself. The forecast gives basic information for analysts to make their forecasts. Later on the allocation decision is released and at this point analysts compare their forecasts to the real outcome. It most likely does not match in every relation. Hence, it is justifiable to ask, what the effects of these surprises are.

I want to move deeper into accounting practises in this question and thereby I separated five common classes of assets. These are current assets, brands, patents, technology, and customer relationships. Moreover, it seemed rational to add goodwill to the classes based on two reasons. Firstly, goodwill seems to be even more interesting than pure asset classes, because goodwill has more dimensions as it appeared in the previous question (Table 3). Secondly, goodwill is a substitute to the other classes, which makes it interesting.

The question referring to the effects of allocation decisions is that in case there is more purchase price allocated to the following accounts in the allocation report than you originally thought at the time of the transaction, how you see the matter. I also represented the opposite scenario that there would be less allocated purchase price to the accounts than expected. The distribution of answers is represented in Table 4.

Table 4 Effects of surprises in the allocation reports

In case there is more/less purchase price allocated to the following accounts in the final PPA report, how you see it? n=25

<b>Scenario 1 More?</b>	Clearly positively; value=1	Slightly positively; value=2	Neutral; value=3	Slightly negatively; value=4	Clearly negatively; value=5
<b>Goodwill ;</b> mean=3,92	4 %	0 %	20 %	52 %	24 %
<b>Current assets ;</b> mean=2,8	8 %	20 %	56 %	16 %	0 %
<b>Brands/trademarks ;</b> mean=2,92	0 %	28 %	52 %	20 %	0 %
<b>Patents ;</b> mean=2,56	0 %	48 %	48 %	4 %	0 %
<b>Technology ;</b> mean=2,64	4 %	32 %	60 %	4 %	0 %
<b>Customer relationships ;</b> mean=2,8	8 %	20 %	56 %	16 %	0 %
<b>Scenario 2 Less?</b>	Clearly positively; value=1	Slightly positively; value=2	Neutral; value=3	Slightly negatively; value=4	Clearly negatively; value=5
<b>Goodwill ;</b> mean=2,36	20 %	44 %	20 %	12 %	4 %
<b>Current assets ;</b> mean=3,12	0 %	16 %	64 %	12 %	8 %
<b>Brands/trademarks ;</b> mean=3,04	0 %	20 %	56 %	24 %	0 %
<b>Patents ;</b> mean=3,4	0 %	4 %	52 %	44 %	0 %
<b>Technology ;</b> mean=3,24	0 %	8 %	64 %	24 %	4 %
<b>Customer relationships ;</b> mean=3,08	0 %	16 %	64 %	16 %	4 %

Essentially Table 4 shows us two results. Firstly, we see which accounts have the strongest impact on analysts and on the other hand which accounts do not have an impact from analysts' point of view. The most notable result is that in four cases out of five in both scenarios a surprise in the amount of goodwill has an effect on analysts. Contrary to this, more than half of the respondents think that allocation surprises in all the other classes than goodwill are insignificant in both scenarios. The only exception is patents in scenario 1, where just nearly 50 percent (48%) of the respondents are saying it is insignificant. The result is in some extent confusing and therefore I cross-tabled the answers. It clarified the results when it comes to goodwill, but all I can say about other asset classes is that a surprise does not have an effect or the reaction does not follow any pattern in the sample. Instead of this, the respondents answering that the effect of goodwill is insignificant in scenario 1, have also answered that goodwill is insignificant in scenario 2. In other words the respondents are the same. Another point to notice is that the respondents, who found goodwill to be insignificant, found as well every other asset class to be insignificant.

The second thing that can be recognised from Table 4 is the causality between an asset class and its effect on analysts. The scenario 1 alone does not reveal that is an effect on analysts because of a surprise itself or because a more aggressive allocation is generally better or worse. This is especially the case with goodwill. In the scenario 1 a surprise in the amount of goodwill is considered as a negative surprise in 76 percents (52 % + 24 %) of the answers. However, it does not tell us whether the negative reaction is because of the surprise generally or because goodwill itself is considered bad for business. The scenario 2 shows us that at least the latter alternative seems to be correct, because in case the amount of goodwill is smaller than expected, 64 percent (20 % + 44 %) of the respondents found that positive. I find more support for the conclusion, when I exclude the answers saying other than a surprise in goodwill is slightly or clearly negative in the scenario 1. This cross-tabling gives a result that 84 percent of the selected respondents considered less goodwill to be a positive sign. This leaves only 16 percent of the selected respondents in favour of a negative impact also in a situation of less goodwill than expected. In other words, they find a surprise in the amount of goodwill always a negative sign.

Unfortunately, I am not able to make any findings concerning single asset classes, because the majority of the answers say that price allocated to the pure asset classes is insignificant. However, the mean values give a modest support to the result concerning goodwill. The mean values of the asset classes are less than three in scenario 1 and more than three in scenario 2. It implies that the more price is allocated to the assets, the better it is, because it is taken away from goodwill.

It seems that I have gathered strong results saying goodwill is not good and thereby companies should avoid it. Hence, it is surprising that the interviewees are not actually



agreeing with the statement. They all think that companies should not avoid goodwill. The explanation is the idea that goodwill just exists and it is not feasible to manage its amount. This would be the ideal theoretical situation, where goodwill is purely a residual and all impairments come from changes in fair values due to changes in economic conditions. However, the survey shows that analysts do not consider goodwill as just a residual and furthermore the interviewees have also recognised the capital market dimension that goodwill has. Hence, it seems more likely that goodwill is much more than a residual.

### 4.3 Discretionary issues in acquisitions

In the third part of the survey I move on to the field of earnings management. I focus on discretion in reporting of acquisitions. Such as in acquisition reporting, I start from a general perspective and continue gradually to more precise questions. I tend to think that it is rational to start with a question about exploiting discretionary in allocation reports in general. I asked that how significantly analysts think that companies use earnings management in acquisitions. The answers are shown in Figure 8.

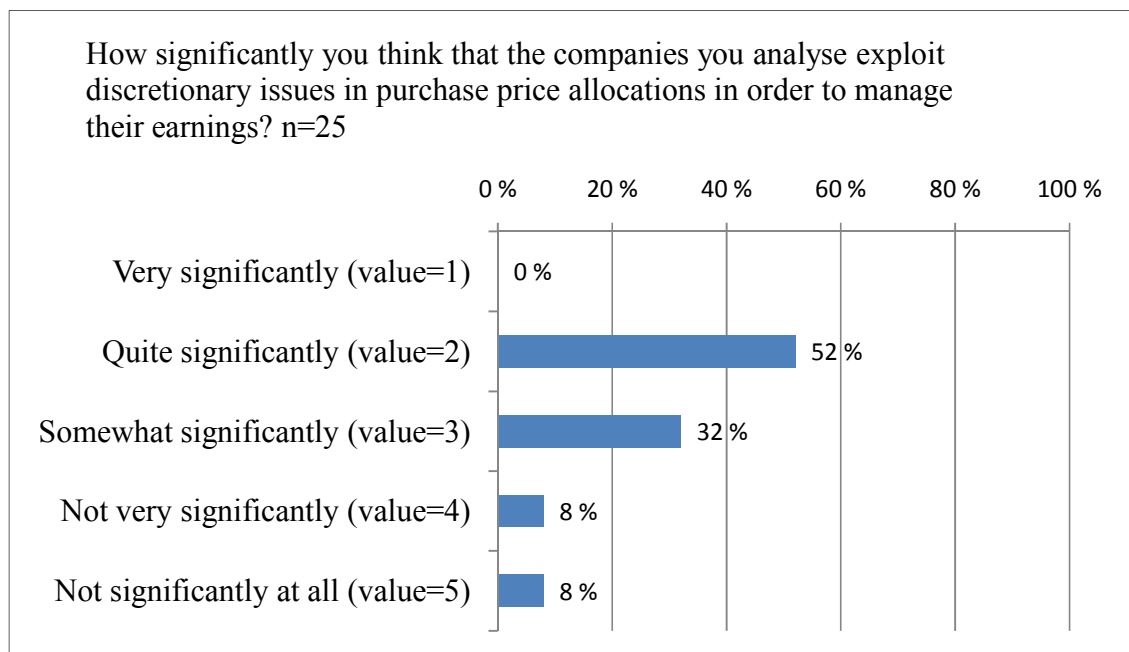


Figure 8 Earnings management in purchase price allocations

We see that more than half of the respondents (52 %) believe that earnings are quite significantly managed and one third of the respondents (32 %) believe that earnings

management is somewhat significant. Altogether this creates a large majority of 84 % of the respondents considering that there is room for earnings management in acquisitions' reporting.

Thinking of the objective of my study, it is clear that I try to bind the theoretical background and the empiric observations together. And because most of the academic earnings management literature concentrates on earnings management in the whole business, I find it reasonable to ask also about earnings management concerning all business operations of a company. The distribution of the answers is shown in figure 9.

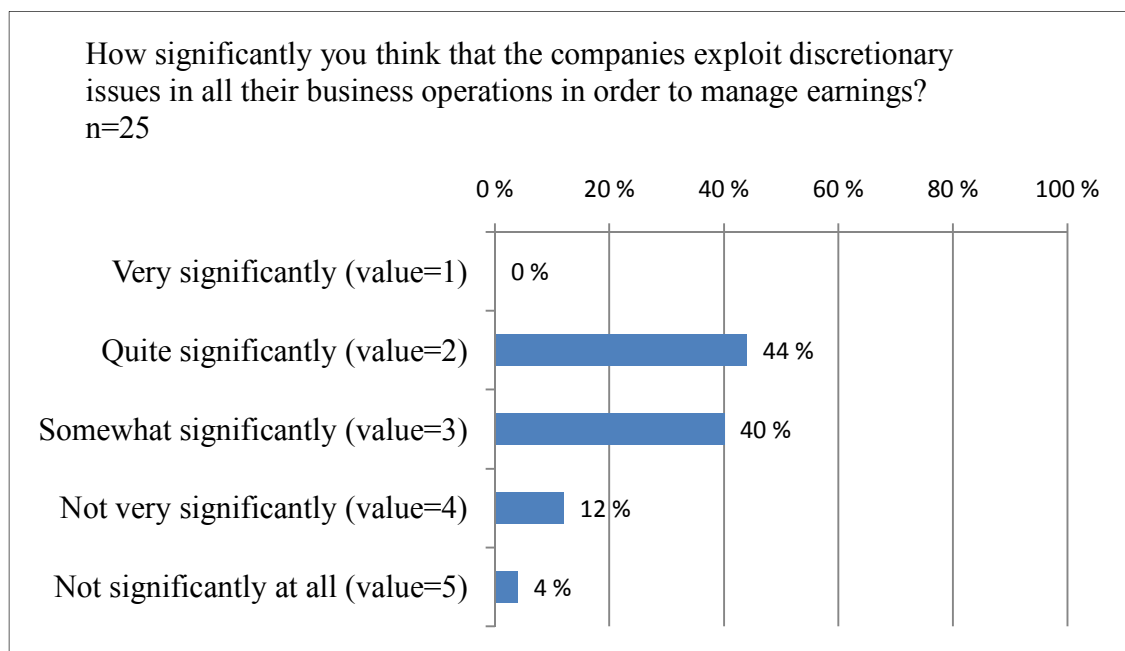


Figure 9 Earnings management of business entities

From the distribution we see that the alternatives quite and somewhat important were the most popular alternatives in this question. They were also the most popular alternatives in the previous question (Figure 8). Moreover, the sum of the two alternatives is exactly the same in the both questions (84 %), but the amount of respondents thinking earnings management is quite significant has dropped a bit in the latter case concerning the earnings management of all operations.

Because the classes quite significant and somewhat significant had the same amount of answers in the questions that are related to each other, it could be possible that the respondents are the same in both questions. However, the cross-tabling revealed to me that the answers are mixed and thereby the respondents are different. Although it would have been interesting to find consistency between the questions, I think that finding the answers to differ from each other do not give possibilities for further analyses concerning the respondents.

The figures 8 and 9 show that a vast majority of the respondents think earnings management exists in some level of significance. The mean values of the answers are 2,7 in figure 4 and 2,8 in figure 5. In other words, this means that the general view about earnings management possibilities in the sample is between somewhat and quite significant, but closer to somewhat significant. Regardless of the strong opinion in favour of existence of earnings management, none of the analysts think that companies are able to manage earnings very significantly in any situation. On the other hand, also only few think that earnings management is modestly significant or not significant at all. These alternatives accumulate 16 percent of the answers in both questions (Figures 8 & 9). We can clearly say that analysts seem to have relatively similar views to earnings management in both relations that I have examined here. That means between the analysts in the sample and between acquisitions and all business operations.

On the other hand, according to the interviews the starting point in analysing financial statements is that announced information is correct. The interviewees think that it is much to assume that companies would find it feasible to manage earnings in order to manipulate the numbers of the whole business. There are various reasons for this. Firstly, it is obvious that accountants' do their job and monitor financial reporting. Especially interviewee 4 came up with this argument. I discussed also the meaning of external parties with interviewee 3. His opinion is that he trusts more in external supervision than in companies' internal supervision that is a supporting argument for interviewee 4's statement.

Whatever is the situation, based on the survey and also the opinions of the interviewees it seems clear to me that neither the external nor internal supervision can cover the opportunistic behaviour completely. Hence, it is not surprising that all the interviewees admit that their analyses concerning acquisitions are not entirely correct. Interviews revealed two basic reasons for this. Firstly, there is the imperfect information of acquisitions. Especially information about the targets of acquisitions is often insufficient, because the target is either a private company or a division of a public company. This supports the result that analysts need more information besides acquisition reports.

The second source of inaccurate forecasts is the use of discretion. On the basis of the results that I have got so far, this is not surprising. More interesting than the result itself are the reasons behind it, because the interviewees seemed to have somewhat different views to the matter. Moreover, it is notable that goodwill seems to play a leading role in causing inaccuracy to forecasts. Interviewee 2 takes the perspective of operational earnings management that refers to earnings management that is done through real actions and not only through accounting procedures. She has seen that even big acquisitions have been postponed because it would have had such a large effect on financial numbers. For example inventories of a company are usually valued to their

cost, but in acquisitions the acquired inventories have to be valued to their fair value. In case inventories do not circle rapidly, it strains the profitability of a company. This effect comes up particularly in the sectors of trade, which is her expertise. According to interviewee 4 operational earnings management and window-dressing are possible in some extent, because they make a company to look more appealing. However, he believes that it is not in the objectives of the buying company, because its target is profitability in the long run. In case a buyer makes an acquisition to look better, it would have to make corrective actions sooner or later and suffer the consequences. That is not reasonable from in his opinion. Furthermore, he points out that in acquisitions there is always a need to be cautious, because it is seen that synergies are often more difficult to achieve than it is thought in the first place. A good example is Nokia. Its acquisition reporting has been very colourful and too positive before they learned to assess the possibilities of synergies properly.

However, in some extent earnings management should not be a problem from capital market's point of view, because it is also analysts' job to see through opportunistic behaviour. This topic came up in particular with the interviewee 1. Hence, we can state that the core of the problem with earnings management from analysts' perspective is the effect of it on earnings forecasts, because after all the most important thing for a stock analyst is that how much the discretion affects his analyses. I asked the question and received a quite broad distribution of answers (Figure 10).

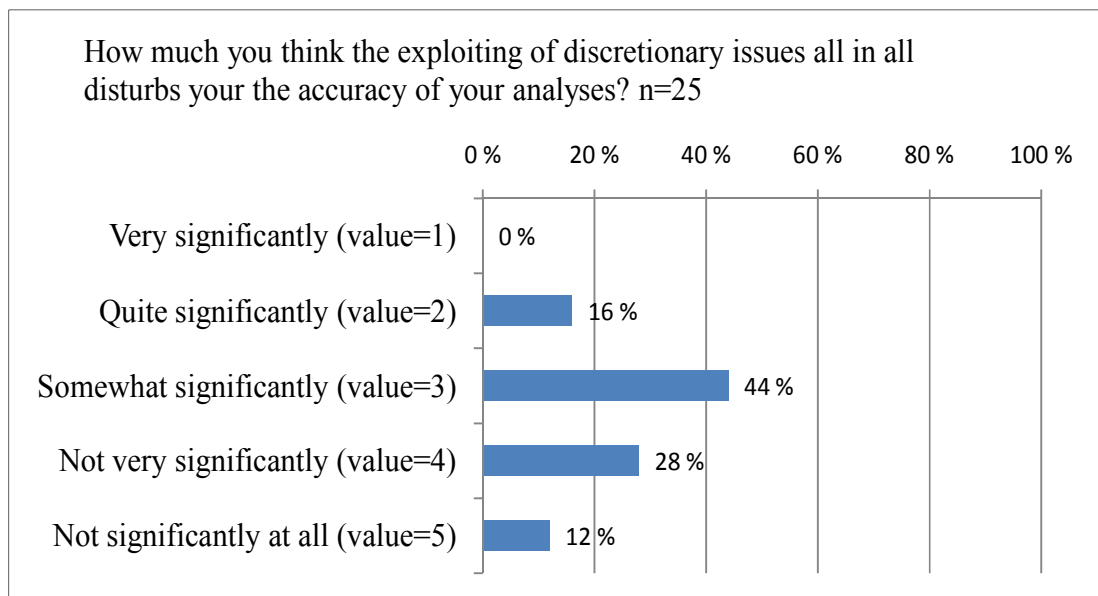


Figure 10 Effect of discretionary issues on analyses

We see that the most common answers are somewhat significant and not very significant. Also the mean value of 3,4 implies that on average analysts think that the extent of earnings management is between the alternatives of somewhat and not very

significant and actually slightly closer to somewhat significant. In the upper as many as 16 percent think that discretionary issues affect quite significantly to analysts' share analyses. Contrary to this 12 percent say earnings management is insignificant and it means that they can either see totally through earnings management or it does not effect on their analyses because of other reasons. However, all in all I would like to point out that nearly nine out of ten respondents (88 %) admit that they are not able to see totally through earnings management and it has at least some effect on their analyses, although it would only be in a level of not very significant. In my opinion the result is supporting the view that exists in the academic literature that earnings management is not only used, but is also worth doing from companies' perspective.

Interviewees were supporting these results and they were also able to motivate their views. Firstly, interviewee 4 states that the inaccuracy in share valuation that comes from financial reporting is purely because of unintended flaws in reporting. He gives an example case about TietoEnator. It based its acquisitions into its own strategy and it was rational to generate goodwill from acquisitions into its balance sheet. TietoEnator had good prospects and it expected to receive benefits from synergies. However, the future did not turn out that positive and its business never worked out as well as it was planned in the first place. The result was a goodwill write-down that affected negatively the profit and share price. The point is that the write-down was a right thing to do, because goodwill is always based on an assumption about a bright future, which just was not that bright in this case. The same logic is applied in the other accounts on the balance sheet as well as in goodwill. It is just that other accounts do not have the same pressure for write-downs and thereby goodwill is the most important single account to follow when it comes to evaluating success in acquisitions.

Secondly, the other interviewees believe that companies are better aware of goodwill and its appreciation. Interviewee 3 sees that companies have the expertise concerning valuation levels of assets and that includes goodwill. He says that it is possible to have a lot of goodwill, but then there has to be a lot of benefits coming from goodwill. This supports the view presented by interviewee 4. But moreover he thinks that companies can avoid the dumping of purchase price to goodwill and allocate the price to other assets. In turn he adds that it is just easier for analysts to discover it from other accounts than goodwill. However, interviewee 3 thinks that companies do not exploit discretionary issues that much in acquisitions than in earnings management in general, because acquisitions are always under scrutiny.

Finally, interviewee 1 and interviewee 2 simply comment that there is room for discretionary issues in reporting of acquisitions. Both agreed with interviewee 3 that there is earnings management concerning the whole business than acquisitions alone. Furthermore, both think that goodwill is the most important single thing. Interviewee 2 points out that the exploitation of discretionary issues depends a lot on managers in the

company.

The vast support that I received for the existence of effective earning management motivates me to carry on deeper into exploitation of earnings management possibilities and to ask that in which accounts companies use most discretion in acquisition situations (Table 5). In this question, I further use the same categorical answering alternatives as I have primarily used through the whole study. However, I return to use the classes that I used in the question concerning importance to report certain information (Table 3). The classes are tangible assets, intangible assets, goodwill and useful lives. The distribution of answers is shown in Table 5.

Table 5      Exploitation of discretion in different asset classes

In what extent you believe that companies exploit discretionary issues in the following accounts when they do purchase price allocation? n=24

	Very significantly; value=1	Quite significantly; value=2	Somewhat significantly; value=3	Not very significantly; value=4	Not at all significantly; value=5
<b><i>Tangible assets;</i></b> mean=3,17	4 %	17 %	46 %	25 %	8 %
<b><i>Intangible assets;</i></b> mean=2,58	4 %	42 %	46 %	8 %	0 %
<b><i>Goodwill;</i></b> mean=2,54	13 %	38 %	33 %	17 %	0 %
<b><i>Useful lives;</i></b> mean=3,04	0 %	25 %	50 %	21 %	4 %

The first finding is that all the accounts are liable to discretion in some extent. However, possibilities of discretion vary from an asset class to another. Tangible assets and matters concerning useful lives seem to have moderate opportunities to earnings management. In turn in intangible assets and goodwill there is considered to have better opportunities of discretion and the mean values of the answers are somewhat lower than for tangible assets and useful lives. Moreover, when I further inspect the answers of intangible assets and goodwill and compare them to each other, I notice the notable difference between the two classes. 92 percent of the respondents found intangible assets to have somewhat or more significant possibilities to earnings management. The

same percentage for goodwill is only 83, but the distribution is flatter. As many as 13 percent think that goodwill includes very significant earnings management possibilities against the four percent for intangible assets. Also a higher percentage thinks that goodwill has less discretionary opportunities than intangible assets, because the alternatives not very significantly or insignificantly have in the case of goodwill 17 percent of the answers and in the case of intangible assets only 8 percent of the answers. All in all it seems that analysts are quite unanimous about the possibilities of earnings management in intangible assets. The matter is not the same in goodwill. A part of the analysts think that there is a good opportunity to earnings management in goodwill and a part thinks quite the opposite.

Now I have gathered the results concerning share analyses themselves. However, I found interesting to ask one more question that is more from the perspective of a reporting company. Because it is clear that the incidence of earnings management differs from a company to a company, it might affect analysts as well. The question is that how earnings management affects the picture that analysts have on company. The objective is to see how analysts tolerate earnings management and the answers imply about the consequences that a company may face when involved in earnings management. Figure 11 shows the results.

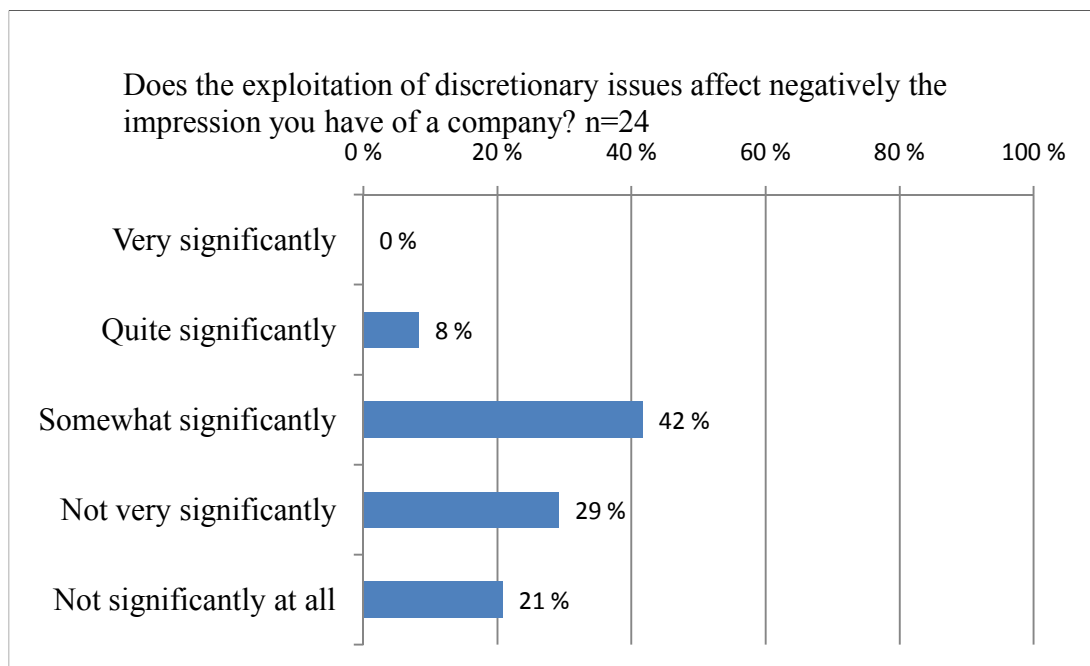


Figure 11 Effects of discretion on company picture

An average answer is between somewhat and not very significant. Less than 10 percent think the negative effect is quite significant and nobody thinks it to be very significant. In the other end, every fifth find it meaningless and 30 percent think earnings

management does not have very significant effect on the picture they have of the company. According to the answers, it can at least be said that analysts do not approve aggressive earnings management. The problem that strains to make strong conclusions about the results is the definition of earnings management that may vary between individuals and might lead to distortions.

#### **4.4 Acquisitions and share valuation**

This research was started by carrying out the survey. The result from the survey has turned out to be very useful, but as it was anticipated already in the beginning of this study, the results of the survey raise new topics that are relevant in this field of research. Naturally, it is not possible to cover all the question that were raised by the survey, but especially the questions concerning share valuation and the most crucial parts of acquisition analyses seem to be vital in understanding the results of the study. Neither was it possible to examine the questions of share valuation by another survey nor wise concerning the complexity of the topic. Hence, the interviews concentrated on share valuation and its implications in acquisitions.

##### ***4.4.1 Methods of share valuation***

On the basis of the survey results most of the inconsistencies in analysts' behaviour lead to the problem of share valuation. This was the conclusion from several perspectives. Firstly, it was considered that the respondents have rather similar views to the existence of earnings management, but when earnings management is connected to share analysis the situation changes. Although the majority of the answers and the average answer show that discretion has only some effect on valuation, the distribution is broad.

Secondly, analysts have different views about the efficiency of earnings management. A part of the analysts say that it is unnecessary to examine earnings management, because it affects only to financial statements that are not critical in share valuations. It even seems that a few of the respondents are answering at the same time that there is an earnings management effect, but it does not affect their share valuation. Hence, it was found very relevant to take a look at the valuation practises. The topic was brought up in the interviews and it was asked that which valuation methods the interviewees are using.

The general finding in the interviews is that analysts use several valuation methods concurrently. All the respondents said that they use all three methods at least sometimes, but there are also notable differences between the analysts. Namely, the



analysts stress the methods differently.

Interviewee 1 said he trusts in discounted cash flow method as a principal method. In addition, he applies multiples in valuation. The multiples are compared to their historical values and to the values of the tier group companies. These are relative measures, but also multiples with absolute measures are used. He names as examples price to earnings (P/E), price to book (P/B) and dividend level. The residual earnings model is rarely used in his case. However, it might be involved in certain parts, when he uses a sum of parts approach. In the approach a company is divided into parts that are evaluated separately and added up after this in order to receive a value for an entity. This approach is also applied, when he sets a target price for a share.

Interviewee 3 applies the discounted cash flow method in the first place as well interviewee 1, but after this interviewee 3 tries to achieve the same result through the residual earnings model. When he has received the two values, he proceeds to use multiples. He comments that although cash flows form the principal part of the valuation, it is important to use other methods besides cash flows. The role of assisting methods increase especially in uncertain economic environment as it is nowadays.

Interviewee 4 applies all the methods equally. He even uses dividend discount model, although it is a simplistic description of cash flows produced by a share. In his opinion it does not matter, because all the valuation methods have its defects. He thinks that the cash flow method is the most common, but he points out the challenges it has. For example it is based on an assumption of everlasting cash flows that are discounted with a weighted average cost of capital (WACC). Firstly, it is impossible to know the cash flows to eternity and secondly, when the WACC changes the answer changes substantially. Furthermore, he admits that he uses multiples, but comments that the multiples are not enough alone. He tends to use two multiples compared to each other. An example is P/B to ROE (Return On Equity). He has also basic rules such as ROIC (Return On Invested Capital) has to be higher than WACC.

#### ***4.4.2 Analyses of acquisitions***

It is obvious that analysts aim at being a step ahead of the markets. This also came up in the interviews. That is why I wanted to ask about analysing acquisitions generally and how the interviewees proceed in their analyses. The final goal is to calculate the effects in total and incorporate them into price models. The problem is that it takes time to calculate the effects and thereby analysts are forced to do a quick analysis about an acquisition. The result is that there is not any structured method to do it, because all the interviewees had different ways to do the first analysis.

Interviewee 1 named three first things to do, when an acquisition is announced. Price

comes first he says. He wants that the purchase price is immediately compared to the values received from the valuation methods that he uses. The second thing is strategic compatibility between the acquiring and the acquired company, which appoints the effects that the acquisition has on the future of the business. This also explains why analysts considered future prospects so important in the survey. Thirdly, the historical accounting numbers of the acquired company are important. Especially, relative key ratios such as profitability are interesting.

Interviewee 2 gives a lot of importance to a quick analysis. She has a list of three bullet points for this. As well as interviewee 1, the first thing is purchase price, which has to be the free from debt price. She comments that we talk about business and in that case price comes always first. She continues that we also talk about invested capital and thus EBIT (Earnings Before Interests and Taxes) marginal of the acquired company is the second thing. The third thing is a measure that reveals how quickly the acquisition turns out to be profitable. This is done by taking the adjusted EBIT that is also known as NOPLAT (Net Operating Profit Less Adjusted Taxes), which is divided by the invested capital. In the next phase, the result is compared to WACC. It tells how quickly the new part becomes profitable.

Interviewee 3 in his turn concentrates as well first on the purchase price and its implications through valuation models. After this, the picture about an acquisition is accompanied by a closer look to the balance sheet of an acquired company. The matters of goodwill are also examined also at this stage.

Interviewee 4 does not have such an accounting concentrated approach to acquisitions as the other interviewees. He begins the evaluation of an acquisition through the strategy of the acquiring company. This reveals what kind of acquisitions the company is looking for and this way it becomes easier to evaluate the acquisition itself. Possible motives are acquiring of technology, customers, new business sectors, new distribution channels, or things comparable to these. He points out that price cannot be the only matter that is looked, because for example the value of a technology is highly dependable on the technologies that are applied in the future and thereby the value cannot be decided today.

One thing that surely affects acquisitions and their reporting is their size. Hence, I asked about the limits of a significant acquisition. Turnover clearly seems to be the most important measure of significance, but turnover should also derive to profits in the same proportion. The result is that generally speaking an addition of about 15 percent in turnover is a notable acquisition and an addition of more than a third of turnover is a very significant acquisition. On the other hand, there are certain things that need to be taken into account. Interviewee 3 tells about his experience that companies may do several small acquisitions during a financial year. None of them is significant alone and they are not properly reported during the financial year, but in the end the multiplicative

effect is notable. This motivates analysts also to concentrate on smaller acquisitions. In turn, interviewee 4 does not want to give specific limits for turnover, because he stresses the strategic meaning of an acquisition. An acquisition might not have a large effect on turnover, but it might have a great influence to the business for example through acquired technologies. This comes up especially in the sector of information technology.

## **5 CONCLUSIONS AND EVALUATION OF THE STUDY**

### **5.1 Conclusions**

The development of international financial reporting standards and the acquisition activity in the recent years have made it current to examine the relation of these two topics. In the IFRS, the standard setter of the regulation has tightened the convention of acquisition reporting and increased the disclosure requirements of acquisition reporting by demanding a purchase price allocation that reveals the allocation of purchase price. On the other hand, acquisitions are always taken into account in the capital markets and thereby companies have incentives to report acquisitions in a positive manner and furthermore strengthen the signal through earnings management. The changes in accounting standards and the incentives to manage earnings affect companies in the first place, but the final impact is seen when the participants on the capital markets are examined. Hence, this thesis has examined the reporting of acquisitions from earnings management's perspective and how it affects analysts. The theoretical framework examines purchase price allocation and earnings management. The perspectives are combined in the empirical studies' section and the outcome is analysed from the analyst perspective. The chosen perspective enables to study the topic from a practical approach. The selected methods of a survey and interviews support the practical orientation of the thesis.

The intention was, firstly, to find out the significance of purchase price allocation reports in the interaction between companies and capital market analysts, secondly, to recognise the most important parts of purchase price allocation from analysts point of view, and thirdly, to reveal the appearance of earnings management in reporting of acquisitions and how it affects stock analysts. These were studied through a survey and deepened with four stock analyst interviews.

The most significant finding of the thesis is that analysts seem to concentrate mostly on goodwill in both acquisition reporting and earnings management in acquisitions. Moreover, intangible assets as well are interesting in both categories. The evidence concerning intangible assets is showing that the interest is resulting from the discretion that the valuation of intangible assets has. The underlying reasons for the interest of analysts to goodwill remain somewhat controversial. However, the examination of individual research questions revealed the problematic nature of goodwill from analysts' point of view.

Firstly, analysts are able to assess acquisitions and the magnitude of earnings management in acquisitions through released information by the acquiring company.

The information can be divided into mandatory and voluntary part. The mandatory information is regulated by IFRS in order to obligate companies to release enough information for external parties to assess acquisitions. The voluntary information is all other information that exceeds the minimal requirements. The results show that the information concerning acquisitions is very important to analysts. However, it turned out that the level of the mandatory information concerning purchase price allocations is not sufficient for most of the analysts, because it does not provide all the needed information for them. From companies point of view it is in some extent understandable that a structured information source such as allocation reports, cannot give all the wanted information in such a complex matter as acquisitions, although it would be the meaning. On the other hand, it is generally notable that many of the inadequacies in the reported information are connected to the first announcement of an acquisition and the inadequacies departs later on when the allocation report is released. This result reveals the clear gap between the needs of capital markets and the possibilities of company reporting. The capital market wants to assess acquisitions immediately, but companies are not able to assess the consequences of acquisitions that quickly, because for example the calculations related to goodwill and synergies need further inspection before a company can assess the matters. Finally, it came up that the additional information needs of analysts are often fulfilled from qualitative sources of information such as company management and this implies that the additional information needs of analysts might be directed to qualitative information instead of quantitative information that is almost entirely regulated in IFRS. This need for qualitative information concerns goodwill in particular, because of goodwill's nature as discretionary issue. In this context the analysts' interest towards goodwill is rational.

Secondly, when thinking of the accounting information that companies release concerning acquisitions, the key elements are shown in the purchase price allocation reports, which help analysts to investigate the success of acquisitions. The survey and the interviews show that the most valued information in purchase price allocation reports from analysts' point of view is the amount of goodwill and prospects about acquired businesses. In respect to the perspective of accounting information in this thesis, a notable finding is thereby the importance of goodwill, which is greater than the importance of tangible assets, intangible assets or useful lives of assets. Theoretically all the asset classes comprise equally much information. Because it is not the case, it reinforces the view that purchase price allocation report is more than just a report of accounting decisions or at least analysts hope to find also other information than financial numbers from the report. On the other hand, it is possible that analysts do not consider other financial information than the amount of goodwill important, but at the same time it would mean that analysts do not fully understand the relation between asset classes, which would explain the different importance of assets classes although the

accounting information is the same. Hence, it is likely that goodwill includes a qualitative part that separates it from the other assets classes.

Thirdly, when moving on to the earnings management perspective in acquisitions, the results show that in most of the cases the respondents found earnings management to be as likely in acquisitions as it is in steering the whole business. This makes it possible to say that the results of the academic earnings management literature can be applied also to acquisition, although the previous researches have concentrated only on earnings management in the whole business. Moreover, this provides the possibility to compare these results to the literature that is introduced in the earlier section of this thesis. Thus, in the light of previous researches, it is not surprising that earnings management is effective at least in some extent (e.g. Gore, Pope & Singh 2007, 123; Brown & Higgins 2001, 374; Kasznik 1999, 58). However, the contribution in this thesis is that also analysts find that earnings management has an effect on their analyses and they find it to be most significant in goodwill and intangible assets, although they do not deny the existence of earnings management in the classes of tangible asset and useful lives. Analysts seem to believe that earnings management is conducted in all asset classes, but because the valuation of intangible assets has most discretion, it is found to be the most likely subject to earnings management in acquisitions. The meaning of goodwill is again puzzling, because analysts think that goodwill has significant earnings management possibilities, but the dispersion of the answers is large. Hence, it seems that different analysts interpret goodwill differently and the conclusions that are made from goodwill vary between analysts. Alternatively, goodwill is very contextual by nature and its meaning and implications are found to be different in separate cases. The interviews tried to detect individual analysts' views to the interpretation of goodwill, but there are not robust evidence showing general implications.

The results show that analysts need more information about goodwill. This in turn means that the information flow between the parties in the capital markets is not perfect. As the goal with IFRS is to contribute to the effective flow of accurate and timely information between companies and investors, there is still room for improvement. However, on the basis of the result in this thesis, it is controversial that can this be reached by concentrating exclusively on quantitative financial information requirements in company reporting. The needs of analysts seem to be more on qualitative information, which comes up in this research in the form of additional information needs for goodwill.

Because analysts seek more information about goodwill, it seems that capital markets are willing to reward companies that give additional qualitative information. Although this does not necessary mean that companies that disclose more about goodwill would be traded on a premium, the disclosures would at least actualize in the form of timelier

information that corrects the share price. In addition, timelier information decreases earnings management possibilities and it could diminish the intentions for earnings management because there would not be as strong incentives for companies to exploit it.

On the other hand, earnings management and discretion in general might be the essential problem in companies' financial reporting from analysts' perspective. On the basis of the results of this thesis, analysts recognise the existence of earnings management, which implies that companies seem to use discretion in reporting. This in turn is likely to create a lack of confidence between analysts and companies. If analysts believe that companies in general manage earnings, it is difficult for an individual company to make the difference and report more reliably, although the company would intend to do so. These problems of reporting easily strengthen the conditions where analysts cannot fully trust the reported financials of companies, but at the same time companies face the same lack of confidence towards capital markets. Hence, there has to be other options to open the locked situation. Naturally, accounting standards regulate the information flow between companies and capital market and it seems that these standards should be developed to a direction, which emphasises qualitative reporting.

## **5.2 Evaluation of the study and further research possibilities**

The sample of this thesis is 25 Finnish stock analysts. It remained relatively small, because the target group that forms the population of the survey consists of 118 analysts. Because of the small sample, it is not possible to generalise the results of the sample to the population. This was anticipated already in the beginning of the research especially because the categorical answering system was chosen to be used in the survey, which sets high requirements for generalisation of the results. Instead of pursuing the possibility to generalise the results, a sound view about the sample was stressed and thereby the interviews were carried out to support the survey.

Although the sample does not fulfil the requirements of generalisation, the high quality of the sample can be emphasised and considered as a strength. All respondents are stock analysts and they come from various brokerages. This is likely to support the intention to pick a homogenous sample. Moreover, the survey is done in a rather long time span that was the whole summer of 2008, which in turn cuts out daily effects such as extraordinary market conditions. In the interviews, respondents were hand-picked in order to get analysts with different backgrounds and industrial sector focuses. Hence, in case the results of the study are criticised, the criticism can be appointed to the selected methods. In surveys it is always possible to criticise matters such as who are the

respondents and why the rest did not answer. In the interviews it can be criticised that does the interviewer guide the interviewees in their answers or how the interview situation affected them. In spite of the possible criticism, this study does not make an exception, because researches can always be criticised. This research was successful in particular in its sample and is likely to describe the true state of matters. Hence, if the empirical part is carried out again, the result would presumably be the same. It is obvious that because of the small sample size, it can easily be skewed in relation to the target group, but in the research there are no signs of distortion what so ever. The results of the interviews are even more concentrated on individuals, but it was noticed as it has come up in the results that the interviewees are unanimous in many topics of discussion. Moreover, the conclusions are made only based on strong evidence in the empirical material and thereby small changes in the results of the survey and the interviews are not likely to change the conclusions concerning the research topic. And because the results are not related to timely economic data, they are robust over time. These elements increase the reliability of the results in this thesis.

The validity of a research looks closely to the design of a thesis. When the goal of the study is assessed, it seems that the right things are measured. As a target group, analysts are quite homogenous, because their job description is rather simple and they have certain rules for every situation. This provides the possibility to examine the topic of the study reliably also through a survey and interviews, although both methods measure actions and opinions that should be carried out instead of actions that are already carried out. On the other hand, the goal was to go deep into analysts' behaviour and thereby the decisions concerning the methods of the study are robustly motivated.

The conclusions raised a couple of interesting questions that could well be further examined. There are strong results concerning goodwill, but nevertheless it was not possible to reveal all the issues that are bound to goodwill. Hence, the possibilities of future examination of goodwill and its implications are pointed out as fertile further research possibilities. Goodwill is an important issue in financial reporting, because it is a very current topic on the capital market and at the same time it seems to be a complex issue for analysts.

Furthermore, the perspective of earnings management provides as well some new questions, although the topic has been under examination for decades. It has been proved that earnings management exists, but it has not yet been fully covered that in which accounts and in what extent it exists. My findings answer to the question, where analysts think that earnings management is exploited. These would give a good baseline for a study that would examine where in acquisitions earnings management is really exploited and how much it affects. Both of the raised questions are challenging, but interesting topics to scrutinise when the perspective of the research is sensibly restricted.



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## APPENDIX 1 THE SURVEY

### PERUSTIEDOT:

- Työnimikkeenne?
- Miten paljon analyysienne kohteena olevat yritykset tekevät mielestänne yrityskauppoja?
  - Alternatives: Keskimääräistä enemmän/Keskimääräisesti/Keskimääräistä vähemmän
- Kuinka hyvin tunnette IFRS 3 -standardin (Business Combinations)?
  - Alternatives: Hyvin/Työni kannalta riittävästi/Huonosti

### YRITYSHANKINTOJEN RAPORTOINNIN MERKITYS:

- Kuinka tärkeänä yritysanalyysienne kannalta pidätte tilinpäätöksissä ja vuoden aikana raportoituja tietoja yrityshankinnoista?
  - Alternatives: Erittäin tärkeänä/Melko tärkeänä/Jonkin verran tärkeänä/En kovin tärkeänä/En lainkaan tärkeänä
- Kuinka hyödylliseksi koette nimenomaan tilinpäätöksen liitetiedoissa olevan yrityshankintaosion (eli liitetietovaatimuksen: hankitut liiketoiminnot)?
  - Alternatives: Erittäin hyödylliseksi/Melko hyödylliseksi/Jonkin verran hyödylliseksi/En kovinkaan hyödylliseksi/En lainkaan hyödylliseksi
- Tilinpäätösten yrityshankintoja koskevat tiedot liittyvät pääosin hankitun liiketoiminnan ostohinnan allokointiin. Etsittekö/saatteko allokointia koskevaa informaatiota myös muualta?
  - Alternatives: Kyllä, ensisijaisesti mistä?/En
- Mikäli saatte allokointia koskevaa informaatiota myös muualta, niin kuinka merkittävä tietolähde tämä on verrattuna tilinpäätöksessä ilmoitettaviin yrityshankintatietoihin?
  - Alternatives: Selvästi merkittävämpi/Jonkin verran merkittävämpi/Yhtä merkittävä/Vähemmän merkityksellinen/Selvästi vähemmän merkityksellinen
- Kuinka tärkeänä pidätte seuraavien tietojen raportointia koskien hankittuja liiketoimintoja?
  - Ostohinnasta allokoitu määrä aineellisille erille
  - Ostohinnasta allokoitu määrä aineettomille erille
  - Ostohinnasta allokoitu määrä goodwillille
  - Keskeisimpien erien poistoaikojen ilmoittaminen
  - Tulevaisuuden näkymät/toimet koskien hankittua liiketoimintaa

- Alternatives: Hyvin tärkeää/Melko tärkeää/Jonkin verran tärkeää/Ei kovin tärkeää/Ei lainkaan tärkeää
- Mikäli ostohintaa on lopullisessa allokointiraportissa kohdistettu ennakoarviotanne enemmän seuraaville erille, niin miten näette asian?
  - Goodwill
  - Vaihto-omaisuus
  - Brändit/tavaramerkit
  - Patentit
  - Teknologia
  - Asikassuhteet
  - Alternatives: Selvästi positiivinen asia/Lievästi positiivinen asia/Ei merkitystä/Lievästi negatiivinen asia/Selvästi negatiivinen asia
- Entä jos ostohintaa on lopullisessa allokointiraportissa kohdistettu ennakoarviotanne vähemmän seuraaville erille, niin miten näette asian?
  - Goodwill
  - Vaihto-omaisuus
  - Brändit/tavaramerkit
  - Patentit
  - Teknologia
  - Asikassuhteet
  - Alternatives: Selvästi positiivinen asia/Lievästi positiivinen asia/Ei merkitystä/Lievästi negatiivinen asia/Selvästi negatiivinen asia

#### HARKINNANVARAISUUKSIEN HYÖDYNTÄMINEN RAPORTOINNISSA:

- Kuinka merkittävästi uskotte analyysienne kohteena olevien yritysten käyttävän harkinnanvaraisuutta (mm. arvonmääritys- ja jaksotustilanteissa) hyödykseen yrityshankintojen ostohinnan allokointia tehtäessä?
  - Alternatives: Hyvin merkittävästi/Melko merkittävästi/Jonkin verran merkittävästi/Ei kovin merkittävästi/Ei juuri lainkaan
- Entä harkinnanvaraisuuksien tuomaa mahdollisuutta koko liiketoiminnan tuloksenhallinnassa (eli ohjaamaan tulosta)?
  - Alternatives: Hyvin merkittävästi/Melko merkittävästi/Jonkin verran merkittävästi/Ei kovin merkittävästi/Ei juuri lainkaan
- Kuinka paljon mielestänne harkinnanvaraisuuksien hyödyntäminen heikentää kokonaisuudessaan teidän analyysienne osuvuutta?
  - Alternatives: Hyvin merkittävästi/Melko merkittävästi/Jonkin verran merkittävästi/Ei kovin merkittävästi/Ei juuri lainkaan
- Vaikuttaako harkinnanvaraisuuksien hyödyntäminen negatiivisesti yrityksen

kuvaan teidän silmissänne?

- Alternatives: Hyvin merkittävästi/Melko merkittävästi/Jonkin verran merkittävästi/Ei kovin merkittävästi/Ei juuri lainkaan
- Missä määrin uskotte yritysten hyödyntävän harkinnanvaraisuutta seuraavien erien kohdalla ostohinnan allokointia tehtäessä?
  - Aineelliset erät
  - Aineettomat erät
  - Goodwill
  - Poistoajat/Taloudellinen vaikutusaika
  - Alternatives: Hyvin merkittävästi/Melko merkittävästi/Jonkin verran merkittävästi/Ei kovin merkittävästi/Ei juuri lainkaan
- Tiedättekö kuka tekee analysoimienne yritysten yrityshankintojen allokointi- ja arvostuslaskelmat?
  - Alternatives: Kyllä/En
- Jos tietäisitte, että joku ulkopuolinen taho tekee allokointi- ja arvostuslaskelmat, niin vaikuttaisiko se teihin?
  - Alternatives: Kyllä, positiivisesti/Sillä ei ole merkitystä/Kyllä, mutta negatiivisesti
- Palautetta ja huomioita kyselystä (vapaaehtoinen)



## APPENDIX 2 INTERVIEW'S STRUCTURE

- Miten analysoit yrityshankinnat?
  - Mitkä ovat keskeisimmät asiat yrityshankintojen raportoinnissa?
  - Onko tiettyä kokorajaa, jolloin yrityshankinta muuttuu niin oleelliseksi, että paneudut siihen tavallista perusteellisemmin?
- Miten määrität osakkeen arvon?
  - Mikä on kassavirtaperusteisen ja tilinpäätösperusteisen arvonmäärittämissuhteiden suhde toisiinsa?
  - Käytätkö niitä rinnakkain?
  - Onko jompikumpi parempi? Miksi?
  - Käytätkö tunnuslukuja ja kertoimia arvonmäärittämisessä? Miksi?

### **APPENDIX 3      DISCLOSURE REQUIREMENTS (IFRS 3)**

The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the end of the period but before the financial statements are authorised for issue.

The disclosures required to meet the foregoing objective are the following:

- Name and a description of the acquiree.
- Acquisition date.
- Percentage of voting equity interests acquired.
- Primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree. Description of the factors that make up the goodwill recognised.
- Acquisition date fair value of the total consideration transferred and the acquisition date fair value of each major class of consideration.
- Details of contingent consideration arrangements and indemnification assets.
- Details of acquired receivables.
- The amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.
- Details of contingent liabilities recognized.
- Total amount of goodwill that is expected to be deductible for tax purposes.
- Details of any transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination.
- Information about a bargain purchase.
- For each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date.
- Details about a business combination achieved in stages.
- Information about the acquiree's revenue and profit or loss.
- Information about a business combination whose acquisition date is after the end of the reporting period but before the financial statements are authorised for issue.