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A Study on the Relevance of the Goodwill Impairment in Context of Audit Partner's Rotation

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Abstract

Currently accounting is in the process of harmonization between the two referential, one issued by the FASB (Financial Accounting Standards Board) - IFRS (International Financial Reporting Standards) and another one by US GAAP (United States General Accepted Accounting Principles/GAAP). This paper analyzes the advantages of adopting corporate governance practices, appropriate to take into account the need to ensure investor regarding the quality of financial information. Research methodology involves analysis of the main studies on adoption of IFRS-IAS in the emerging markets, using qualitative research techniques, research carried out on the basis of specialized literature. The purpose of this article is to present an overview of the implementation of International Accounting Standards, illustrating the relevance of goodwill in the context of audit partner's rotation. The implementation of IFRS arose from the need to align with EU regulations, while opening access to international capital markets and enhancing the comparability and transparency of information in the financial statements. The data were extracted from the financial statements of the companies under investigation. To meet the objectives of the research were selected and analyzed, in addition to articles that form the basis of the literature, a number of 262 companies. The results show that the difference between the ability to explain the two models to test the impact of rotation of audit partners on the relevance of annual financial statements, one with AR variable included, one in which AR variable is excluded, is that the rotation of audit partners has a distinct impact on the relevance of financial statements in relation to other variables included in the model, including those relating to gross goodwill and to its impairment. One may observe the lack of a significant interaction between the impairment of goodwill and investors' perceptions, due to the quality of audit engagement in emerging markets analyzed.

Keywords: *IFRS, goodwill, relevance, stock exchange*
JEL Classification: *M41, G34, C30*

1. Introduction

Currently accounting is in the process of harmonization between the two referential, one issued by the FASB (Financial Accounting Standards Board) and another by US GAAP (United States General Accepted Accounting Principles/GAAP), which requires to listed companies to prepare financial statements in accordance with US GAAP. Standards issued by the IASB (International Accounting Standards Board) are known under the acronym of IAS-IFRS (International Accounting Standards - International Financial Reporting Standards) and are used in several Member States of the European Union, in particular being used by listed companies in Australia, Russia, South Africa, Singapore, UK. Standards to be used in the European Union must be approved by the ARC (Accounting Regulatory Committee), in cooperation with the EFRAG (European Financial Reporting Advisory Group).

Adoption of IFRS International Accounting Standards has a positive impact, proven by empirical studies, in terms of increasing the quality of financial information. Adebimpe O. Umoren, Raymond Ekwere Enang, 2015 *IFRS Adoption and Value Relevance of Financial Statements of Listed Nigerian Banks*, International Journal of Finance and Accounting, ISSN: 2168-4812, ISSN: 2168-4820, 4 (1): 1-7 doi: 10.5923 / j.ijfa.20150401.01, analyzes in their study, based on a sample consisting of 12 bank financial institutions, the relevance influence on financial statements. The analysis is conducted for both IFRS pre-adoption period and the period that is following it. The results show that the value of equity is relevant when applying IFRS.

2. Reporting period

In order to meet the information needs of users, financial statements are prepared at the end of the reporting period, respectively, at national level referring to the financial year (if we are talking about economic entities or public institutions) and coincides usually with the calendar year, starting on January 1st, or it starts on the establishment of the company and ends on December 31 or on the dissolution of the company. In the United States the reference period is the fiscal year, while in countries such as Australia and New Zealand is starting on 1st July and end on June 30, in Japan and in Canada beginning on April 1st and ending on March 31.

3. Structure and content of financial statements

The layout is the vertical one (with few exceptions such as Italy, Germany), preferred also by USA. The structure and content of financial statements differ, so, the national legislation orders the current assets in increasing way, depending on the liquidity and the liabilities and equity also in increasing way, depending on the chargeability. Under US GAAP on balance sheet, the assets are shown in descending order and the liabilities ascending. The Income Statement, in terms of national legislation, includes revenues and expenses classified by their nature, while under international law the elements are ordered both by nature and by function. The Cash Flow Statement has the same structure, according to IAS 7 *Statement of Cash Flows*, using both direct and indirect methods. Statement of Changes in Equity presents the equity items. In the American version, there is the profit distribution statement and shares' status. The final component of the package of financial statements differ, respectively called *Notes to the Financial Statement*s, while in the United States are called *Other Items*. This situation presents the necessary information to all users.

Auditors, as users of financial information, are involved in accounting normalization, given that the audit function is an important mechanism of corporate governance. To this purpose it is necessary a strong interaction between the external audit function and investors.

Audit firms attended public consultation sessions of IASB. These audit firms have expressed support for measures of assessment of goodwill at fair value (both in the section on SMEs and the one on the public-interest entities). After updating the accounting standards for public companies, audit firms promoted fair value measurement for SMEs, citing comparability of annual financial reports. In this respect, auditors such as BDO (BDO Global Coordination, 2007) supported in 2007 the prescribed treatment by IFRS 3 "Business Combinations" for small and medium enterprises.

It can be seen in the case of Iron Workers Mid-S. Pension Fund ex rel. Caterpillar Inc. vs. Oberhelman (2013) that audit firms do not yet have a proper methodological basis for evaluation in business

combinations and the initial recognition of goodwill. Inappropriate maintenance of the audit firm responsible for ensuring investor Caterpillar generated an unprecedented scandal in 2013 after the adoption of Sarbanes-Oxley Act.

One of the problems that were evident by analyzing the annual financial statements of the American firm was audit partner's rotation. Emby and Faver-Marchesi (2005) demonstrated in 2005 that the likelihood of depreciation on goodwill is reduced if companies did not have a suitable rotation of audit partners. One explanation for this phenomenon is given by Brown and Knechel (2013) proving the relationship compatibility of audit partners and their customers through their similar size

From this point of view, we can say that emerging markets are likely to form an oligopolistic competition, favouring only those international audit firms with adequate financial resources. As noted in the methodology provided by the rating agency S & P (McGraw Hill Financial, 2014), emerging markets should have a capital market developed, but quantitative criteria no provisions regarding the number of entities listed and therefore can no stock exchange with a limited number of listed entities for audit firms to compete. We can therefore say that the issue of frequent rotation of audit partners is more severe in emerging markets than in developed economies.

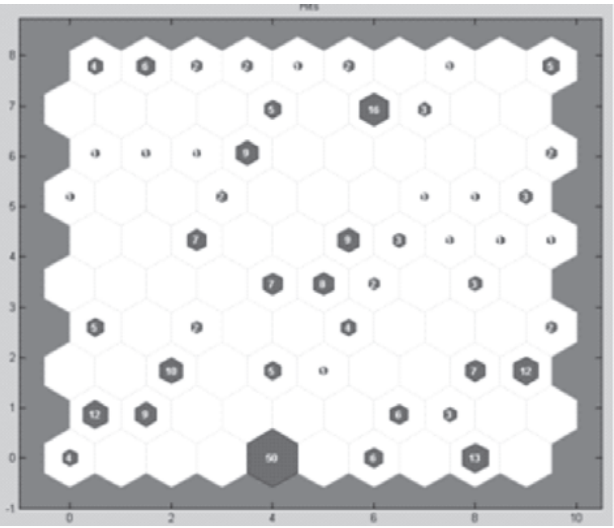
4. The research methodology and the obtained results

The objective of accounting is to provide information required to all users, regarding the company's financial position and performance. The aim of the research is the analysis of the benefits of adopting corporate governance practices appropriate to take into account the need to ensure investor regarding the quality of financial information. Research methodology involves analysis of the main studies on adoption of IFRS-IAS in the emerging markets, using qualitative research techniques, research carried out on the basis of literature. Research data were extracted from the financial statements of companies included in the sample under investigation. To achieve the objective of the research were selected a number of 262 companies listed on stock exchanges in emerging markets. The sample is representative, non-random, which we believe reflects the structure of emerging economies and expectations regarding goodwill impairment. In the study conducted by ACCA in 2014 (Tsalavoutas et al., 2014) were selected a number of 23 developed and emerging markets to assess the degree of compliance with IASB on goodwill impairment. Similarly, our sample shows a total of 23 emerging markets. From the point of view of concentration observations, index Hirshman-Herfindahl distribution in jurisdictions reflect a distribution relatively isotropic (in the sense that the coefficient is 11%, compared to 4% as would be obtained if the distribution was purely uniform across jurisdictions).

The main criteria for sample selection were: the presence of ending balance or footing of the goodwill during the year under review; Shari'ah certification for companies operating on an Islamic market (Nigeria, Egypt, Saudi Arabia, UAE, Malaysia and Indonesia) and membership in the retail sector for emerging economies dependent on public or policy makers (India, Brazil China, Hong Kong). Because according to the database Thompson Reuters Eikon, number of business combinations made from the emerging markets between listed companies represent 13% of the global total in July 2015 and signal impairment of goodwill is rare, according to Current Account ACCA (Tsalavoutas et al., 2014), the sampling process was influenced by the need to obtain a significant number of entities that have impaired goodwill equal to or greater than 31% of all companies analyzed. The last criterion considered for modeling sample was that of eliminating the risk of duplication of observations by the parent companies and subsidiaries inclusion in the sample if they were listed simultaneously. In order to observe the distribution of the sample and its representativeness, was chosen a neural network adapted to issues such as "clustering", to capture the distribution of observations sector (implemented by Thompson Reuters relating to that business), headquarters (based on area code) large exposure to the risks related to the 10 largest capital markets within they operate (following IHH index on percentages allocated by Thompson Reuters Eikon) and view the audit report of the annual financial statements reported (1 if the opinion is unqualified, 0.5 if it is unqualified with explanations and 0 if qualified).

Figure 1. Distribution of observations, neuronal network ("clustering")

(first test)

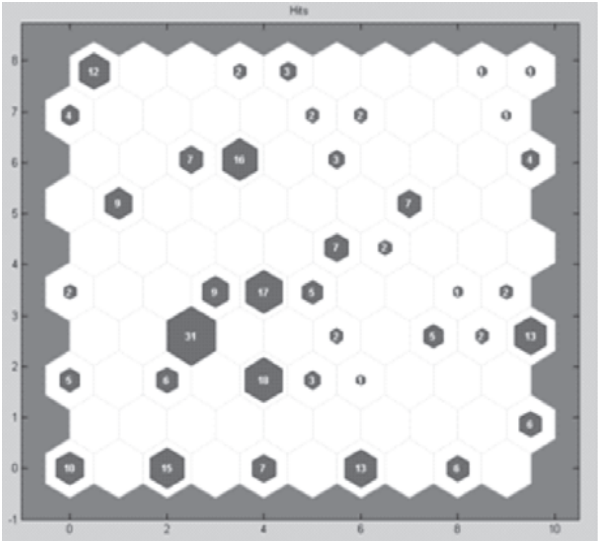


48% from total possibilities at global level

Source: authors' projection in MatLab 2011b

Figure 2. Distribution of observations, neuronal network ("clustering")

(second test)

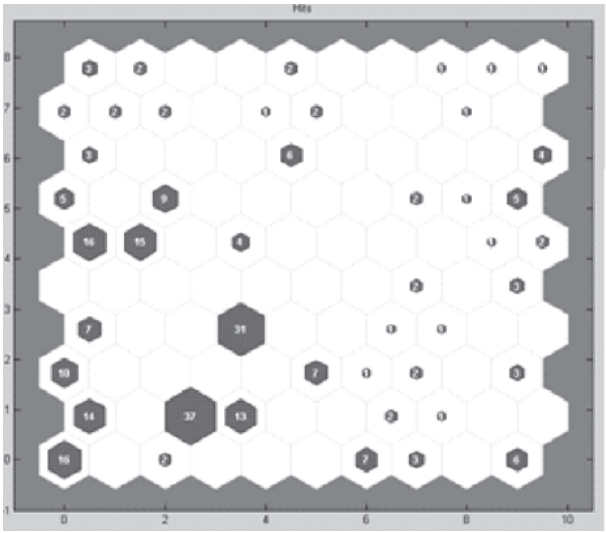


39% from total possibilities at global level

Source: authors' projection in MatLab 2011b

Figure 3. Distribution of observations, neuronal network ("clustering")

(third test)

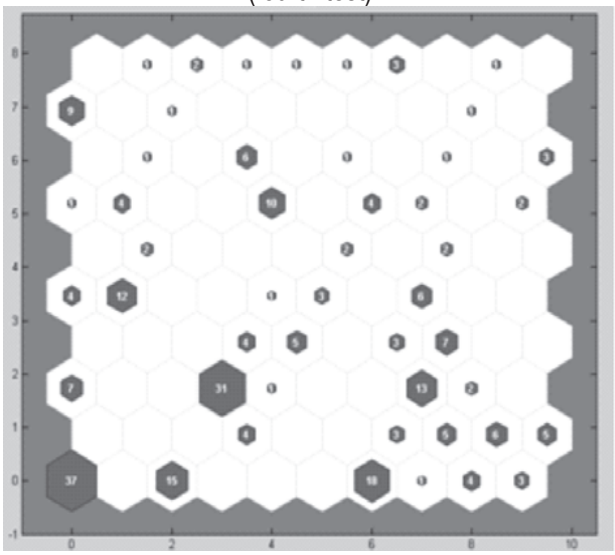


46% from total possibilities at global level

Source: authors' projection in MatLab 2011b

Figure 4. Distribution of observations, neuronal network ("clustering")

(fourth test)



49% from total possibilities at global level

Source: authors' projection in MatLab 2011b

After four successive simulations (Figure 1, Figure 2, Figure 3, Figure 4) in the neural network built in Matlab 2011b we found that, on average, the selected sample reflects 45.5% of all possible combinations that could be brought within the scope, the audit opinion, the geographical distribution and specific risk exposure to financial markets interact. In our opinion, this reflects the representativeness of the sample topography.

Although studies on assessing the relevance of goodwill were performed mainly on samples panel (Ojala, 2007; Xu et al, 2011 Hamberg and Beisland, 2014), it opted for a cross-sectional analysis similar to that conducted by LaPointe -Antunes et al (2009). In principle, the level of studies in the literature developed by researchers prefers capital markets in countries such as Finland, Sweden, the UK or Canada. Because financial exercises differ from one jurisdiction to another, we opted for those financial years ending on 30.06.2013, 31.12.2013, 30.06.2014, 09.30.2014 and 10.31.2014 to ensure data homogeneity.

Regarding the variables of interest to study, they are capitalization at the reporting date, adjusted by the number of ordinary shares (CBA), equity adjusted with goodwill value (KA), net profit before goodwill impairment (PRNA), goodwill impairment (FCDA) and the amount of goodwill before the impairment expenses (FCA). These variables are addressed in the model developed by Lapointe-Antunes et al (2009), in a study conducted on the Canadian market. The only difference between the two methodologies occurs in the dependent variable CBA, which was collected right at the initial reporting date for the entity.

The first control variable introduced in our study relates to the interest shown by analysts for news from the company (IA). This is a dichotomous variable that takes value 1 if the entity is monitored by at least one analyst and 0 - otherwise.

A second control and interest variable is the audit partner rotation (RA). This is a dichotomous variable that takes value 1 if the last four financial audit reports for annual financial statements were signed by the same audit partner and 0 - otherwise. Under the Sarbanes-Oxley Act (107th Congress, 2002), the audit partner should be changed after a maximum of five consecutive annual reports audited. Therefore, considering that this is the standard for quality audits and emerging markets, it opted for four consecutive financial years, on the assumption that existing audit partner continues its audit mission by the end of this year.

Regarding the independent and dependent variables signs, those were adjusted according to the methodology described in the study Lapointe-Antunes et al (2009) the number of ordinary shares. Also to homogenize data on financial reporting currency we opted to convert financial information in US dollars.

To test the impact of rotation of audit partners on the relevance of annual financial information we opted for two regression models, one with variable RA included, one in which variable RA is excluded, as well as for Mann-Whitney test in order to compare beta coefficient obtained from the two models. To illustrate the normal distribution of the dependent variable was chosen CBA Benford's Law, according to which a sample showing an abnormal distribution of the first digit of observation will generate a significantly Z-score. We believe that the sample size permit this test. To detect multi-collinearity we used VIF coefficient, which must have a value between 1 and 10. The independence of observations was assessed by Durbin-Watson test and for verifying homoschedasticity the Ljung-Box test was chosen.

$$CBA = \beta_1 + \beta_2 \times FCA + \beta_3 \times KA + \beta_4 \times PRNA + \beta_5 \times FCDA + \beta_6 \times IA + \beta_7 \times RA + \varepsilon$$

(model 0)

$$CBA = \beta_1 + \beta_2 \times FCA + \beta_3 \times KA + \beta_4 \times PRNA + \beta_5 \times FCDA + \beta_6 \times IA + \varepsilon$$

(model 1)

The results can be seen in the Tables 1 and 2. Fisher, Ljung-Box and Durbin Watson tests are met for both models, but model 1 has the advantage of a degree of freedom (DFE) lower than 0. Therefore model 1 provides an adequate explanation of the phenomenon analyzed.

Table 1. Results for both models

Anova	Model 0	Model 1	Anova	Model 0	Model 1
Fisher	25.200	21.6503	Freedom degrees	256	255
MSE	271.525	269.478	Regression	5	6
Adjusted R Square	31.68%	32.19%	Durbin-Watson	2.0771	2.1134
Observations	262	262	Ljung-Box Q-test	11.78%	17.1%

Source: authors' projection

Table 2. Descriptive statistics for variables

	Model 0					Model 1				
Variables	Beta	SE	t Stat	P-value	VIF	Beta	SE	t Stat	P-value	VIF
Free term	2.2733	1.8972	1.198	0.232	X	3.398	2.000	1.698	0.091	X
FCA	1.6370	0.5140	3.185	0.002	2.104	1.495	0.519	2.882	0.004	2.159
KA	0.2473	0.0624	3.961	0.000	2.574	0.239	0.062	3.828	0.000	2.590
PRNA	0.9558	0.4039	2.366	0.019	2.708	0.987	0.403	2.451	0.015	2.714
FCDA	-3.993	1.4286	-2.795	0.006	2.136	-3.809	1.427	-2.668	0.008	2.148
IA	5.416	2.2517	2.406	0.017	1.030	5.569	2.245	2.481	0.014	1.032
RA	X	X	X	X	X	-3.975	2.000	-1.716	0.087	1.040

Source: authors' projection

It can be seen that the parameter RA presents a negative coefficient in the model, which is consistent with results obtained by Wang and Tuttle (2009), who identifies a significant drop in auditors' cooperation with their customers if they introduce a mandatory rotation of audit partners. The lack of such cooperation can be seen by underperformance on the stock markets where the entity is traded, as a consequence of the limitation of creative accounting practices, especially at the intangible assets and goodwill levels. All the factors incorporated in the model are significant and non-collinear.

5. Conclusions

From Mann-Whitney test and from multi-collinearity statistics it is obvious that the difference between the ability to explain the two models consists in the fact that the audit partner's rotation has a distinct impact on the relevance of financial statements in relation to other variables from the model, including those relating to gross value of goodwill and to its impairment. Thus, we can observe the lack of a significant interaction between the impairment of goodwill and investors' perception on it, caused by the quality of audit engagement at the level of emerging markets analyzed.

The lack of interaction between these variables is likely to be caused by the lack of a section in the audit report devoted specially to valuation accounting problems, such as assessment of compliance and opportunity of goodwill impairment by auditors. These problems may lead investors to look at audit quality separately from financial information in the annual reports, including extraordinary expenses, such as those resulting from goodwill impairment. Future research directions, build on the researched issues, could involve inclusion of developed markets in the sample.

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