

商譽追溯調整的決定因素： 評估國際財務報導準則第一號的意涵

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摘要：本文旨在探討何種因素造成有些英國公司選擇把購併取得的商譽由股東權益的減項追溯認列於資產負債表的無形資產。雖然大部分公司選擇避免追溯認列而直接保留商譽於股東權益的減項，但仍有些公司在首次適用英國第十號公報（商譽）時，選擇成本較高的追溯認列法。我們的實證結果指出，樣本公司通常在有較高的負債時會選擇追溯認列法，符合「債務訂約」假說。但「訊號假說」、「政治成本假說」與「權益訂約假說」並未獲得支持。當公司採追溯調整法處理過去由購併而取得商譽，其動機可能來自於為降低財務困難的成本及未來重新協議新的優惠債務條件等。由於英國第十號公報與國際財務報導準則第一號——首次適用，在商譽部分的規定極為相似，而臺灣在 2013 年將全面採行國際財務報導準則，我們認為英國商譽的會計處理準則適用過程與經驗，有助於提升各界對國際財務報導準則首次適用的認知與瞭解。同時，我們的研究結果也指出，首次適用對於追溯認列豁免權的選擇性，可能使公司在採用國際財務報導準則的過渡時期留有操縱的空間。

關鍵詞：IFRS 1、FRS 10、商譽、重估、追溯調整

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The Determinants of Goodwill Reinstatements: Assessing the Implications of IFRS 1

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Abstract: This study aims to examine the determinants that affect UK firms' choices to retrospectively reinstate acquired goodwill as an intangible asset when it was reported as an equity deduction in the balance sheet. While most firms choose exemption from the retrospective application, some firms opt for costly reinstatement when they first adopt UK FRS 10. Empirical results indicate that companies with high debt contracting costs choose the retrospective application, in line with the "debt contract hypothesis." However, none of the hypotheses concerning "signaling theory," "political cost," and "equity contracting" are supported by the findings. The sampled firms reinstate goodwill with the incentive to reduce the financial distress costs and to increase the possibility of renegotiating new debts in the future. As the requirements of goodwill accounting for UK FRS 10 and IFRS1 are similar, the UK procedures and experiences for goodwill accounting provide good models for Taiwan, where the first adoption of IFRS is expected to take place in 2013. In addition, exemptions from retrospective application could possibly provide companies leeway for manipulation during the transitional period of IFRS adoption.

Keywords: IFRS 1, FRS 10, goodwill, restatement, retrospective application

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1. INTRODUCTION

On May 14, 2009, Financial Services Authority in Taiwan (TFSA) announced that all public companies in Taiwan are required to adopt International Financial Reporting Standards (IFRS) for their consolidated financial statements from 2013 onwards. The policy is to align with the global trend, which more than a hundred countries in the world have been following, or encouraging convergence with IFRS. However, the adoption of IFRS involves a radical change in the domestic generally accepted accounting principles (GAAP), which in turn might cause some adverse impacts on financial reporting practices and subsequent severe economic consequences.

This paper, in particular, is concerned with the extensive influence of IFRS 1. IFRS 1—*First Time Adoption of International Financial Reporting Standards*, requires that the first-time IFRS adopters should retrospectively apply IFRSs to all past accounting periods in most areas. In other words, firms that adopt IFRSs must restate its opening balance sheet figures for the transition period in the way as though they have adopted IFRSs since firms' establishment. However, as one could imagine, this might bring huge costs more than the actual benefits received. IFRS 1 thus allows exemptions of retrospective application in sixteen areas. In the context of business combination, according to IFRS 1, Appendix C1 (which deals the exemption application of business combinations), a first time adopter may elect not to apply IFRS 3 (2008) retrospectively to past business combinations;¹ however, if a first-time adopter restates any business

¹ This includes not to restate previous business combinations or not to bring back the goodwill that were originally written off to equity. Paragraph C4 (i) of Appendix C in IFRS 1 (exemptions for business combination) prescribes that, if a first-time adopter does not apply IFRS 3 retrospectively to a past business combination, and if the first-time adopter recognizes goodwill in accordance with previous GAAP as a deduction from equity, it shall not recognize that goodwill in its opening IFRS statement of financial position. The reason why Paragraph C4 (i) does not allow companies to reclassify goodwill previously written off to reserves from equity section to assets is that companies do not adopt "retrospective approach." This does not mean that IFRS 1 disallows the retrospective approach for business combination if firms previously recognize goodwill as a deduction from equity.

combinations to comply with IFRS 3 (2008), it shall restate all later business combination from that same date (Appendix C1). Specifically, if a firm in Taiwan chooses not to restate previous business combination, the carrying amount of goodwill in the opening IFRS balance sheet will be its carrying amount under Taiwanese GAAP (i.e., TFAS 25 or IFRS 3, 2004) at the transition date. However, if firms in Taiwan choose to adopt the regulations in IFRS 3 (2008)—*business combinations* retrospectively to past business combinations (para. 13, Appendix C1), then firms need to restate goodwill as if firms had adopted IFRS 3 (2008) since the effective date of IFRS 3 (2008). If a company in Taiwan restated a business combination that occurred on January 1, 2009, it shall also restate all business combinations that occurred between January 1, 2009 and the date of January 1, 2012. Furthermore, firms also need to comply with IAS 36 impairment testing to the restated goodwill.

Taking advantage of a setting in the UK where the spirit of domestic GAAP is more aligned with that of the IFRSs and where options of retrospective application are also allowed, this paper investigates whether firms take advantage of the transitional regulations on mergers and acquisitions. The UK setting has a unique property on examining the determinants that influence a firm's choice to adopt retrospective method rather than to apply exemption rules to reflect the economic substance of business combination transactions during the transition period.

Prior to 1997, when FRS 10—*Goodwill and Intangible Assets* was released (ASB, 1997), UK firms were given options of choosing between immediate write-off goodwill to reserves and capitalization of goodwill with systematic amortization. A dominating percentage of 97% of UK firms favoured immediate write-off to reserves, as the treatment can often avoid huge amount of amortization expenses.² Nevertheless, the direct write-off method causes a large depletion of shareholders' equity and an

² FRS 10 required firms to capitalize goodwill and amortize the cost over a 20-year period, exception allowed. When UK adopts IFRSs, the amortization is not required anymore, but impairment testing needs to be considered in goodwill value measurement.

overstatement of return on assets, which has twisted the economic substance of business combinations. In 1997, FRS10 was thus introduced to mandate all purchased goodwill be capitalized as an intangible asset and amortized over its useful economic life. FRS 10 represents a radical shift in the accounting treatments for purchased goodwill on future business combinations in the UK. With no mandatory requirement of retrospective application of FRS 10, companies have the choice of leaving any already written-off-to-reserve goodwill to where it was, i.e., a deduction of equity. Alternatively, companies can apply the transitional rule to bring back all the purchased goodwill that was previously “buried” in the equity to balance sheet as an intangible asset (i.e., goodwill).³ Since adopting FRS 10 retrospectively is at the discretion of management, it will be interesting to explore whether the option to reinstate goodwill is based on the professional judgement to convey private information to investors, or whether it is associated with firms’ incentives to manipulate accounting numbers to reduce the contracting costs (Watts and Zimmerman, 1986; Citron, 1992a, 1992b; Defond and Jiambalvo, 1994; Day and Taylor, 1995, 1996a, 1996b). Analogously, while the first-time adoption of IFRSs mandates a change in GAAP, it offers a number of options in the first year. Managing financial reporting with the options provided for IFRSs first-time adopters will impair the quality of first-year IFRS statements and affect the quality of financial statements after the transition period (Capkun, Cazavan-Jeny, Jeanjean, and Weiss, 2008). Our examination on a firm’s accounting choice in the previous mergers or goodwill written-off to reserves can provide insights on how a firm manages earnings through accounting discretion.

Following prior literature (Watts and Zimmerman, 1986), we consider contracting costs, signalling theory, political costs and equity contracting factors in influencing the voluntary choice of reinstating the previously written-off goodwill. Using a matched sample approach, we

³ In other words, companies recognize goodwill as prior year adjustments and intangible assets.

examine the differences in these factors between the retrospective reinstators and the control firms. Our results find that firms reinstate goodwill to reduce the cost of financial distress costs and to increase the possibility of renegotiating new debts in the future. As goodwill reinstatement can increase the value of shareholders' equity, and decrease leverage ratio, the results support the debt contracting hypothesis (Grinyer, Russell, and Walker, 1991). However, we do not find evidence that support the information signalling theory, political cost and equity contracting hypotheses.

Our contributions to the literature are three folds. First, we contribute to the debt contracting theory (Watts and Zimmerman, 1986; Duke and Hunt, 1990; Healy and Palepu, 1990; DeFond and Jiambalvo, 1994; Sweeney, 1994) by providing another avenue through which managers can mitigate the debt contracting costs. In our setting, as the restatements require a great deal of accounting costs to calculate the "as if" goodwill numbers for the previous business combinations, it is interesting to explore the factors that make firms give up the "easy-going" exemption rule but follow the retrospective application regulation. Second, we contribute to the accounting standard literature (Harris and Muller III, 1999; Leuz and Verrecchia, 2000; Barth, Landsman, and Lang, 2008) by examining the accounting choices during the transitional period such as IFRS 1 on whether retrospective restatement of past business combinations should be prohibited, permitted or required (IFRS 1, Basis for Conclusions [BC hereafter], BC32-34). Third, our study provides important implications for Taiwan's financial reporting regulations. Although the legal regime and institutional background might differ to a great extent between Taiwan's and the U.K.'s, managerial incentives to use the accounting discretion to meet managers' private motives have been observed universally. In particular, prior literature has found that companies have incentives to inflate the value of total assets to reduce the leverage and the risk to violate the debt covenants (Mather and Peasnell, 1991; Lin and Peasnell, 2000a). Our empirical studies based on the accounting option

during the transitional period in the U.K. can provide useful implications for companies, investors, creditors and regulators in Taiwan. If the adoption of IFRSs in 2012 is highly likely to cause enormous impact on the financial reporting, the options provided in IFRS 1 might provide leeway for manipulations. Investors and regulators in Taiwan should be cautious in interpreting the performance during the transitional period.

The rest of the paper is structured as follows: Section 2 describes institutional backgrounds; Section 3 discusses the development of our research hypotheses; Section 4 describes sample selection process and variables measurement, Section 5 elaborates on the results from the empirical tests, sensitivity tests are provided in Section 6. Section 7 concludes this paper.

2. INSTITUTIONAL BACKGROUND—IFRS 1 VS. FRS10

2.1 IFRS 1 and Business Combinations

IFRS 1 (2008)—*First Time Adoption of International Financial Reporting Standards* requires first-time IFRS adopters prepare a presentation of at least one year of full comparative financial statements in accordance to IFRSs. The major considerations for IFRS 1 are that, information should be transparent, comparable and cost should not exceed the benefits to users (para. 1). As IFRS 1 is applied only once for the first time adoption of IFRSs, the general principle is that all standards in force at the first IFRS reporting date should be applied retrospectively to the comparative financial information. However, considering the costs of providing this information, IFRS 1 also allows firms the options to exempt from the restatement and measurement principles in certain areas.

Specifically, if Taiwanese firms need to comply with IFRSs for all financial years from January 1, 2013 onwards, January 1, 2012 is the transitional date and January 1, 2013 is the application date for IFRSs, with the reporting date being December 31, 2013. The opening balance sheet numbers on January 1, 2012 must be restated as if IFRSs had been applied since firms' inception. However, the retrospective application

mandated in IFRS 1 exempt sixteen areas from this rule, business combinations included. All detailed regulations concerning business combinations, including the treatment for goodwill, are listed in the Appendix B of IFRS 1.

Business Combinations in Taiwan: IFRS 3

Our focus is on the exemption for goodwill recognition. Whilst TFAS 25—Business Combinations was revised in 2005 (effective for fiscal year 2006) to adopt the IFRS 3 (2004 version), TFAS 25 will not be revised to align with IFRS 3 (2008) version before the full adoption of IFRS in 2012. The main changes between IFRS 3 (2004) and IFRS 3 (2008) relate to recognition of assets at fair value, restructuring costs, business combinations achieved in stages and negative goodwill which should now be taken to profit and not used to reduce the fair value of assets acquired. The main changes can be summarized as follows:

1. IFRS 3 (2008) also applies to business combinations involving only mutual entities and business combinations achieved by contract alone, which were excluded from the scope of IFRS 3 (2004).
2. Transaction costs incurred by the acquirer in connection with the business combination are not included in the acquisition costs and hence goodwill under IFRS 3 (2008). This was allowed under IFRS 3 (2004).
3. Under IFRS 3 (2008), the acquirer can elect to measure non-controlling interest at fair value at the acquisition date, or at its proportionate interest in the fair value of the identifiable assets and liabilities of the acquiree. However, IFRS 3 (2004) only allows the second option (i.e., no goodwill for non-controlling interests). The first option requires the recognition of goodwill to their full fair values rather than being stepped up only to the extent of the acquirer's ownership interest in the acquiree. While this option is mandatory under USA FAS 141R, IFRS 3 (2008) provides a second option that was consistent with IFRS 3 (2004). The second option allows an acquirer to recognize goodwill up to the extent of the acquirer's ownership interests, and does not recognize goodwill for non-controlling interests. The additional choice in IFRS 3 (2008)

departing from that of the IFRS 3 (2003) provides a possibility for companies to have a leeway to increase the value of goodwill in consolidated statements, if they choose to recognize goodwill for non-controlling interests.

A first-time adopter in Taiwan can elect not to apply IFRS 3 (2008)—*Business Combinations*, retrospectively to past business combinations for the opening book value of goodwill on January 1, 2012, and can thus choose not to adjust the comparative financial information in compliance with IFRS 3 (2008). By choosing retrospective application, a first-time adopter can increase the value of goodwill on the balance sheet, but the firm should also carry out a formal impairment testing of all goodwill recognized in its opening IFRS balance sheet. On the other hand, if a first-time adopter chooses not to restate any past business combinations, the carrying amount of goodwill in the opening IFRS statement of financial position shall be its carrying amount in accordance with Taiwanese GAAP (i.e., IFRS 3, 2004) or any other domestic standards at the date of transition to IFRSs.

Examining the accounting option during the transitional periods provides an insight into managers' behaviours when they face a drastic change in financial accounting standards. In particular, as the restatements require a great deal of accounting costs to calculate the "as if" goodwill numbers for the previous business combinations, it is interesting to explore the factors that make firms give up the "easy-going" exemption rule but follow the retrospective application regulation. Prior literature (Mather and Peasnell, 1991; Lin and Peasnell, 2000a) have found that companies have incentives to inflate the value of total assets or total equity because creditors determine the creditworthiness based on the leverage (i.e., total liability divided by total assets). Thus, if the firm in Taiwan is under financial distress, choosing the retrospective approach of IFRS 3 (2008) allows companies to increase the value of goodwill from the fair value for the acquirer's ownership interest in the acquiree to the whole fair value that also includes the non-controlling interest portion of the acquiree.

The increased value of total assets can help mitigate the firm's risk of violating the debt covenants. However, firms may have to bear the rather huge costs of the potential decreases in its value in the subsequent reporting periods because the possibility to occur a write-off under the impairment testing is greatly increased.

Other incentives that companies in Taiwan might choose retrospective approach for IFRS 3 (2008) to inflate the value of goodwill include the demand for raising equity or renegotiating debt in the future. The details can refer to section 3.

2.2 FRS 10 in the U.K.

To shed further lights on the incentives, we exploit the setting in the UK where firms are not required to reinstate past purchased goodwill numbers that were treated as a deduction from equity in its opening FRS statement of financial position. It would be crucial to explore why firms make tremendous efforts to reinstate the goodwill that was previously "buried" in the equity when adopting FRSs. In particular, the accounting choice during the transitional period may produce certain effects at the time of adoption in the transitional year and the opposite effect over a longer time period.

It was a controversial issue of how to account for goodwill in decades in the U.K. The major regulations were seen in Statement of Standard Accounting Practice (SSAP) No. 22—*Accounting for Goodwill* (ASB 1984 and revised in 1989), where companies have an option of choosing between the immediate write-off of goodwill directly to reserves (the write-off method) and capitalization of goodwill with subsequent amortisation. A survey conducted by Tonkin and Skerratt (1995) reveals that the vast majority of the U.K. companies preferred adopting the write-off method (a dominating 97%), because firms can avoid the huge amortization expenses when adopting the direct write-off method. However, the immediate write-off method often led to a heavy depletion of shareholders' equity, an overstatement of returns on assets, and does

not follow the global trend of capitalization of goodwill. To address the concerns, Financial Reporting Standard (FRS) No.10—*Goodwill and Intangible Asset* was released in 1997, mandating all purchased goodwill to be capitalized and prohibited the choice to write off goodwill to reserves.

FRS 10 represents a radical change in the accounting treatment for purchased goodwill. The standard is effective from 1998 and early adoption is encouraged. For the past goodwill that was written off to reserves (the amount might be gigantic due to accumulation over a rather long period of time), FRS 10 does not stipulate any mandatory retrospective treatments. Instead, companies have the choice to leave any already written-off-to-reserve goodwill unchanged or to reinstate previously written-off goodwill as intangible assets in the balance sheet. The reinstatement of goodwill would require the firm to apply amortization rules each year or to conduct the impairment testing when amortization rule is not applicable, which can then weaken firms' income statement, and hence cause a lower return on assets in the future.

3. HYPOTHESIS DEVELOPMENT

Taking advantage of a setting in the UK where the spirit of domestic GAAP is more aligned with that of the IFRSs and where options of retrospective application are also allowed, this paper investigates whether firms take advantage of the transitional regulations on mergers and acquisitions. Since the reinstatement decision is at the discretion of management and the relevant numbers are usually enormous, it will be interesting to explore whether the option to reinstate goodwill is based on professional judgement to convey private information to investors, or it is associated with firms' incentives to manipulate accounting numbers to reduce contract costs (Watts and Zimmerman, 1986).

Many studies have examined the economic determinants of a firm's accounting choices (Watts and Zimmerman, 1986). In this study, following Fields, Lys, and Vincent (2001) and Watts and Zimmerman (1986), we propose a number of determinants that may influence the decision for UK

firms to reinstate goodwill in their financial statements based on three theories of accounting choices.

3.1 Debt Contract Costs

We first propose that accounting choices might be determined to affect the firm's contractual arrangements by alleviating the agency costs between the firms and the contracting parties, such as debt contracts (Watts and Zimmerman, 1986). Studies by Citron (1992a; 1992b) and Day and Taylor (1995; 1996a; 1996b) examine the form of UK debt covenant restrictions. Citron (1992a; 1992b) find that the majority of UK bank loan contracts were based on extant GAAP. Day and Taylor (1995) find that leverage is the main accounting variables used in bank loan covenants in the UK. Mather and Peasnell (1991) find that firms in the UK tend to capitalize Brands in order to reduce high leverage. Grinyer et al. (1991) and Lin and Peasnell (2000b) also find that debt contracting is the main reason that can influence the determination how acquisition price is assigned to net tangible assets and therefore to goodwill. Gore, Taib, and Taylor (2000) find, in a December 1994 questionnaire study, that many finance directors of listed UK companies believe that goodwill accounting treatment would explicitly or implicitly affect their debt covenant restrictions.

The efficient contracting view holds that management who acts in the best interests of their common shareholders will aim to minimize bankruptcy costs (Watts and Zimmerman, 1986). Companies may find the choice to reinstate goodwill is a powerful tool through which companies can mitigate the expected costs arising from accounting-based debt covenants. To the extent that some covenants are written in terms of book value of shareholders' equity, we expect firms that have high leverage will be more likely to reinstate goodwill, because the direct write-off method would deplete equity.

We use leverage as a measure of the tightness of debt covenant restrictions. A relative high leverage within an industry is taken as a

general signal of financial distress and poorer creditworthiness and may further cause lawsuits. To ensure consistency between reinstator and control companies, the level of leverage is measured prior to the reinstatement effect is at work.

H1: The decision to reinstate goodwill voluntarily is positively related to the level of leverage prior to reinstatement effect is at work.

3.2 Equity Contract Costs

Another type of contractual arrangements involves the parties between managers and shareholders (Watts and Zimmerman, 1986). One unique setting in the UK is that the London Stock Exchange Listing Rules over the study period require costly shareholders' approval if the acquisitions are sufficiently large. Specifically, any of the following percentage is above 25%, companies should seek shareholders' approval because this is usually costly. The criteria used to measure the significance of the acquisitions are as follows:

Net assets: the net assets (defined as capital and reserves) of the subject of the transaction divided by the net assets of the listed firm.

Profits: the profits attributable to the net assets of the subject of the transaction divided by the profits of the listed firm.

Consideration to net assets: the consideration for the transaction divided by the net assets of the listed firm.

Consideration to market capitalisation: the consideration for the transaction divided by the aggregate market value of all the equity shares of the listed firm.

Gross capital: the gross capital of the subject of the transaction (which for this criterion has to be a company or a business) divided by the gross capital of the listed firm.

For example, if companies have acquisitions where any of the listed percentage targets is above 25%, the transactions are termed as "Super Class I" and this would require informing the London Stock Exchange of the transaction, holding an extraordinary general meeting to approve the

acquisition, and would further incur administrative expenses and professional fees. Mather and Peasnell (1991) and Muller III (1999) both find that Super Class I transaction classification can affect voluntary accounting choice issues relating to brand capitalisation. Thus, we argue that, as Super Class I transaction relates to significant amount of shareholder approval costs, this would provide an incentive for managers to reinstate goodwill to increase net assets to avoid such costly procedural actions. Thus, we provide our second hypothesis as follows:

H2: The decision to reinstate goodwill voluntarily is positively related to the number of foreseen Super Class I transactions avoided in the following year by the decision to reinstate goodwill.

3.3 Political Costs

Watts and Zimmerman (1986) argue that larger firms are more vulnerable to facing political exposure penalties than smaller firms due to a higher level of scrutiny. If size can be an imperfect proxy for political costs, we expect that larger firms may not adopt this reinstatement decisions to prevent drawing regulatory attention to them. Thus, following Fields, Lys, and Vincent (2001), we provide our third hypothesis as following:

H3: As firm size increases, it is less likely that a firm reinstates goodwill voluntarily.

3.4 Information Signalling

Fields et al. (2001) argue that accounting choice may provide a mechanism by which better informed managers can reveal information to less well-informed investors about the magnitude, timing and risk of future cash flows. Under information signalling hypothesis, managers are compensated based on their ability to signal value-relevant information. They will make accounting choices that impart their expectations about firms' operating prospects. Following Hand and Skantz (1998), we argue that healthier firms may signal their solid financial conditions and/or

higher future profitability through restating goodwill as capitalized assets. The information signalling hypothesis predicts that:

H4: The decision to reinstate goodwill voluntarily is positively related to the level of return on total assets measured after the transition year of the reinstatements.

3.5 Financing Considerations

Muller III (1999) suggests that the possibility that a firm can renew existing finance with debt holders and acquire new equity issues hinges on the financial health of the firm. Therefore, we conjecture that reinstatement of goodwill can help managers strengthen their balance sheet, such as increased net worth and assets base, which in turn can positively influence lenders in renegotiating existing finance, or influence shareholders to make additional investments in the period following the reinstatement.

H5a: The decision to reinstate goodwill voluntarily is related to the proportion of a firm's debt due for renegotiation.

H5b: The decision to reinstate goodwill voluntarily is positively related to a firm's issuance of equity securities.

4. SAMPLE SELECTION AND RESEARCH DESIGN

4.1 Sample Selection and Data Source

Our empirical analyses are based on matched-pair sample. First, goodwill reinstators are identified by searching an electronic database of UK annual reports for all UK listed non-financial firms, including both live and dead companies obtained from DATASTREAM, for year ends between 31 December 1995 to 31 December 1999.⁴ We hand collect our "reinstators" by looking through the reserves footnote of companies' financial statements. The sample firms are termed "Retrospective

⁴ The period was chosen because the first announcement of the FRS 10 draft was in 1995, and the mandatory adoption date for FRS 10 is 1998, since it was an voluntary option to reinstate goodwill, the sample period can catch most of the "voluntary reinstators."

Reinstators (RR),” which are companies that reinstated the goodwill that were previously written off to reserves and now bring it back to the balance sheet as intangible assets in the year of adopting FRS 10. The procedure yields 54 firm-years for RR firms.

Second, each reinstator is matched with a non-reinstator that is in the same year and industry (FTSE Level 6 code), and has a size (total assets) closest to that of the reinstator. Specifically, non-reinstators refer to those firms that choose the exemption option under FRS 10 and leave the goodwill that were previously written off to reserves unchanged. For each reinstator, we initially identify a group of non-reinstators with the same industry classification and year as the reinstator and choose the non-reinstator with assets that are closest to the reinstator. As a result, we obtain 54 firm-year observations for non-reinstators and hence 108 observations for the matched-pair sample. This matching procedure helps us both to minimize possible omitted variables problems and self-selection bias. Table 1 displays all companies of reinstators and control sample.

As DATASTREAM makes certain adjustments for immediately written-off goodwill, for example, in calculating its total assets figures, we also hand collect information on total assets, goodwill, reinstated opening goodwill, associate and joint venture goodwill (where disclosed), other intangibles, goodwill amortisation and reported equity for reinstators and control companies from the current and preceding year’s financial statements. Data are also hand collected from the financial statements in the following period after reinstatement for the future financing variables, such as debt and other long-term financing from cash flow statements and relevant notes, share issues from “Reconciliation of Movements in Equity,” acquisitions and disposals of subsidiaries. The market value of equity at the year end of the reinstatement year (HMV) was collected from DATASTREAM.

Table 1 Retrospective Reinstators and their Matching (Control) Companies

<i>Retrospective Reinstators</i>	<i>Industry</i>	<i>Year End</i>	<i>Matching Firms</i>	<i>Year End</i>
Pilkington	Building Materials	31/03/1999	Norcros	31/03/1999
10 Group	Media Agencies	31/12/1998	Chime Comms	31/12/1998
Rotork	Eng. Contractors	31/12/1998	Spirax-Sarco Eng	31/12/1998
Chemring	Defence	31/10/1998	Ultra Electronics Hldgs	30/12/1998
SCI Entertainment	Home Entertainment	30/06/1998	Rage Software	30/06/1998
Northern Leisure	Leisure Facilities	04/07/1999	GR Holdings	30/06/1999
Blick	Electronic Equipment	30/09/1999	Abacus Group	30/09/1999
Gladstone	Software	30/06/1998	Macro 4	30/06/1998
Mayflower Corp	Auto Parts	31/12/1998	Bostrom	31/12/1998
Lookers	Vehicle Distribution	31/12/1999	Dixon Motors	31/12/1999
Homestyle Group	Retailers, Soft Goods	03/01/1998	N. Brown Group	28/02/1998
Coburg Group	Food Processors	30/04/1998	Sidney C. Banks	30/04/1998
Gowrings	Restaurants And Pubs	31/12/1998	City Centre Restaurants	31/12/1998
Babcock International	Engineering, General	31/03/1998	FKI	31/03/1998
GEI International	Engineering, General	31/03/1999	600 Group	03/04/1999
Orbis	Security And Alarms	31/03/1998	Reliance Security Group	01/05/1998
Reuters Group	Publishing + Printing	31/12/1997	Hemscott	31/12/1997
United Buss Media	Publishing + Printing	31/12/1998	Newsquest	03/01/1999
Reed Elsevier	Publishing + Printing	31/12/1998	Highbury House	31/12/1998
Wilmington Group	Publishing + Printing	28/02/1999	Southnews	03/04/1999
EMAP	Publishing + Printing	31/03/1999	Sterling Publishing	31/03/1999
Semple Cochrane	Business Support	30/06/1999	Ricardo	30/06/1999
Fountains	Business Support	30/09/1999	Aukett Group	30/09/1999
Porvair	Chems.Advanced Mats.	30/11/1999	Zotefoams	31/12/1999
Capital Radio	Broadcasting	30/09/1998	Carlton Comms	30/09/1998
Scottish Radio Hldgs	Broadcasting	30/09/1999	Granada	25/09/1999
Seacon Holdings	Shipping And Ports	30/09/1998	Fisher (James) & Sons	31/12/1998
GEC Marconi	Telecom Equipment	31/03/1999	Intelek	31/03/1999

Table 1 Retrospective Reinstators and their Matching (Control) Companies (continue)

<i>Retrospective Reinstators</i>	<i>Industry</i>	<i>Year End</i>	<i>Matching Firms</i>	<i>Year End</i>
Barbican Healthcare	Med Equip + Supplies	31/12/1997	Crestacare	31/12/1997
African Lakes Corp.	Internet	06/10/1999	Netcentric Systems	30/09/1999
Britannia	Other Construction	31/12/1997	AMEC	31/12/1997
Aim Group	Aerospace	30/04/1998	Hampson Industries	31/03/1998
Whitecroft	Diversified Industry	31/03/1998	Lawrence	31/03/1998
Dowding & Mills	Electrical Equipment	30/06/1998	Thorpe (F.W.)	30/06/1998
Booth Industrial Group	Eng. Contractors	30/09/1998	Lincat	30/06/1998
Finelist Group	Vehicle Distribution	30/06/1998	Fieldens	30/06/1998
Dentmaster Hldgs	Vehicle Distribution	30/06/1998	Reg Vardy	30/04/1998
Quicks Group	Vehicle Distribution	31/12/1996	Dagenham Motors Group	31/12/1996
Stoves Group	Hsehold Apps+Hsewares	31/05/1998	Jourdan	30/06/1998
Usborne	Food Processors	30/06/1996	Sygen International	30/06/1996
International Greetings	Publishing + Printing	31/03/1998	Wyndeham Press	31/03/1998
Universe Group	Security And Alarms	31/12/1997	Protec	30/06/1997
Ws Atkins	Business Support	31/03/1998	Mitie Group	31/03/1998
Weeks Group	Business Support	31/03/1998	AEA Technology	31/03/1998
World Telecom	Business Support	31/12/1997	Tracker Network	31/12/1997
Api Group	Business Support	03/10/1998	Eurocopy	30/09/1998
Pascoes	Education + Training	03/01/1998	Hat Pin	31/12/1997
Constellation Upton	Education + Training	25/07/1998	Northern Recruit. Grp	30/06/1998
British Fittings Group	Distribution	31/12/1997	Spandex	31/12/1997
Greenway Holdings	Environmental Control	31/03/1998	Shanks Group	28/03/1998
Baltimore Techn	Software	30/04/1998	Planit Holdings	30/04/1998
Primar Glow Comms	Computer Services	30/11/1998	QA	30/11/1998
Gremlin Group	Home Entertainment	31/07/1998	Eidos	31/03/1998
Kewill Systems	Software	31/03/1998	Total Systems	31/03/1998

4.2 Research Designs

In order to test the joint effect of the determinants on the decisions to reinstate goodwill, we employ the following dichotomous logit model.

$$REINSTATE_{it} = \alpha_0 + \alpha_1 LEV_{it} + \alpha_2 CLASS_{it+1} + \alpha_3 SIZE_{it} + \alpha_4 \Delta ROA_{it+1} + \varepsilon_{it} \dots\dots\dots (1)$$

$$REINSTATE_{it} = \beta_0 + \beta_1 LEV_{it} + \beta_2 CLASS_{it+1} + \beta_3 SIZE_{it} + \beta_4 \Delta ROA_{it+1} + \delta_{it} \dots\dots\dots (2)$$

$$REINSTATE_{it} = \gamma_0 + \gamma_1 LEV_{it} + \gamma_2 CLASS_{it+1} + \gamma_3 SIZE_{it} + \gamma_4 E_ISSUE_{it} + \gamma_5 Debt_Due_{it} + \eta_{it} \dots\dots\dots (3)$$

The dependent variable, *REINSTATE_{it}*, is set equal to one for the sample firms that restate (or reinstate) goodwill and zero for the control firms that do not restate goodwill. Our independent variables are cross-sectional determinants for the voluntary reinstatement of goodwill, which require additional adjustments and are explained as follows.

1. Leverage (*LEV_{it}*): In order to make comparisons between reinstator and matching companies, leverage is calculated on a common basis, excluding the effects of the reinstatement decision. This is achieved by adjusting the leverage of reinstator companies using total assets before reinstating goodwill to make the ratios directly comparable for the sample and control firms. For robustness tests, we measure debt contracting costs with the change in leverage (ΔLEV_{it}). The results are qualitatively similar.
2. Numbers of Super Class I transactions (*CLASS_{it+1}*, *CLASS_{it}*): As it is difficult to measure the number of foreseen Super Class I transactions which could be avoided by goodwill reinstatement, following Muller III (1999), we use the number for firm i during year *t+1* that could avoid shareholder approval requirements under London Stock Exchange’s “Class Test Rules” due to the goodwill reinstatements. We explore the notes in the financial statements for the year following the reinstatement year for details of acquisitions and disposals. In line with Muller III (1999), we use two ratios to determine whether the acquisition is above

the threshold—25% of the ratio between net assets to total assets, and consideration paid to total assets were used.

3. Size ($Size_{it}$): $Size_{it}$ is the natural logarithm of sales for the reinstatement year. Instead of using total assets, we use the value of sales as a proxy for size because it is unaffected by the decision to reinstate goodwill.
4. Information signaling (ΔROA_{it+1}): ΔROA_{it+1} is the change in returns on total assets between year t and $t+1$. Similar to the measure for LEV_{it} , we remove the reinstatement decisions from ΔROA_{it+1} to make the ratios directly comparable to the sample and control firms. Specifically, for the reinstators, we remove the book value of “reinstated goodwill” from total assets (i.e., the denominator element) and add amortization expense attributable to the reinstated goodwill back to “earnings before interest” (i.e., the numerator element). The purpose of the adjustment is to derive ΔROA_{it+1} as if the reinstator had not reinstated goodwill from equity section to assets.
5. Future long-term financing ($Debt_Due_{it+1}$ vs. E_ISSUE_{it+1}): Following Muller III (1999), we proxy for the future long-term financing using the future debt renegotiation variable ($Debt_Due_{it+1}$) and the future equity new issuance (E_ISSUE_{it+1}). $Debt_Due_{it+1}$ is defined as debt due in year $t+1$ for firm i , scaled by total assets before reinstating goodwill at the end of year t . E_ISSUE_{it+1} is defined as proceeds from common stock issuance in year $t+1$ for firm i divided by the firm’s market capitalization at the end of year t . We also use alternative measures for future long-term financings. We use net debt actually raised in the year $t+1$, or total funds raised in year $t+1$ as *ex post* rather than *ex ante* measures. Such alternative specifications did not affect in any material way, as the results report.

Finally, we control for industry fixed effects in our regressions to address substantial variation across industries. We also control for year effects to consider time-series variations.

5. EMPIRICAL RESULTS

5.1 Descriptive Statistics and Univariate Results for Matched Pairs

Panel A of Table 2 reports the descriptive statistics for retrospective reinstators group (RR group) and Panel B reports the results for control sample of non-retrospectively reinstating firms. In Panel A, we find that the mean value of the originally reported leverage (LEV_{it}) for retrospective reinstators group is 0.58, which is very similar to control sample, the mean value being 0.57 in Panel B. However, after removing the reinstatement effects, the mean leverage for retrospective reinstators prior to reinstatement effects increases to 0.74 and so does ΔLEV_{it} increasing from -0.04 as published to 0.12 before firms reinstate goodwill. When testing matched pair mean differences using t-test, and non-parametric median results using the Wilcoxon signed rank test, the mean (median) differences are significant (t -value = 0.01; z -value = 0.01). In addition, return on total assets for one-year-ahead of the reinstatement year (ΔROA_{it+1}) is much lower for the RR group, even in the reported figures, which is inconsistent with the information signalling hypothesis (t -value = 0.05). The results suggest that firms that have retrospectively reinstated goodwill are more associated with low profitability than their counterparts. Consistent with Muller III (1999), our results also indicated that in the year following the goodwill reinstatement, the sample firms can make more acquisitions that could avoid stock exchange mandated shareholder approval through reinstating goodwill ($CLASS$) than the control firms; the sample firms can renegotiate more debts ($Debt_Due$) and issued more equity (E_ISSUE) in the year following the reinstatement of goodwill than the control sample, though only the mean difference in $Debt_Due$ is significant.

Table 3 shows the correlation matrix for the various explanatory variables. In general, the correlation matrix shows no multicollinearity concerns.

Table 2 Descriptive Statistics for Retrospective Reinstators and Respective Control Samples

<i>Panel A: Companies Which Have Retrospectively Reinstated Goodwill</i>							
<i>Variables</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Q1</i>	<i>Median</i>	<i>Q3</i>	<i>t-test</i>	<i>Wilcoxon test</i>
LEV_{it} as published (after reinstatement)	0.58	0.18	0.42	0.57	0.72	0.79	0.94
LEV_{it} (before reinstatement)	0.74	0.30	0.49	0.69	0.88	0.00***	0.01***
ΔLEV_{it} as published (after reinstatement)	-0.04	0.23	-0.10	-0.03	0.03	0.82	0.55
ΔLEV_{it} (before reinstatement)	0.12	0.30	-0.02	0.04	0.15	0.01***	0.01***
ROA_{it+1} as published	-0.15	1.08	0.02	0.07	0.18	0.01***	0.00***
ROA_{it+1} without opening reinstatement	-0.11	1.09	0.00	0.08	0.22	0.01***	0.03**
ΔROA_{it+1} as published	-0.24	0.99	-0.12	-0.04	0.02	0.05**	0.09*
ΔROA_{it+1} adjusted for opening reinstatement	-0.21	0.99	-0.10	0.00	0.07	0.03**	0.00***
$SIZE_{it}$	11.45	2.24	10.40	11.20	13.25	0.98	0.77
$CLASS_{it+1}$	0.16	0.80	0.00	0.00	0.00	0.24	0.50
$Debt_Due_{it}$	0.12	0.16	0.02	0.06	0.16	0.07*	0.14
E_ISSUE_{it}	0.13	0.33	0.00	0.00	0.06	0.15	0.23

Table 2 Descriptive Statistics for Retrospective Reinstators and Respective Control Samples (continued)

Panel B: Control Sample of Non-Retrospectively Reinstating Companies

<i>Variables</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Q1</i>	<i>Median</i>	<i>Q3</i>
LEV_{it}	0.57	0.20	0.49	0.58	0.70
ΔLEV_{it}	-0.03	0.14	-0.06	-0.01	0.03
ROA_{it+1}	0.12	0.09	0.05	0.15	0.18
ΔROA_{it+1}	0.06	0.28	-0.02	0.00	0.04
$SIZE_{it}$	11.44	1.65	10.15	11.52	12.43
$CLASS_{it+1}$	0.04	0.20	0.00	0.00	0.00
$Debt_Due_{it}$	0.07	0.06	0.02	0.05	0.10
E_ISSUE_{it}	0.06	0.15	0.00	0.00	0.02

1. *, ** and *** respectively indicate significant at the 10%, 5% and 1% level in a two-tailed test.
2. Variable definition: LEV_{it} is financial leverage, defined as the ratio of total debts to total assets for firm at the end of year t ; ΔLEV_{it} is change in financial leverage between year t and $t-1$; ROA_{it+1} is earnings before interests at time $t+1$ divided by average total assets between the period t and $t+1$; ΔROA_{it+1} is the change in return on total asset between year t and $t+1$; $SIZE_{it}$ is the natural log of net sale; $CLASS_{it+1}$ is the number of transactions for firm i during year $t+1$ that could avoid shareholder approval requirements under London Stock Exchange class test rules due to the reinstatement of goodwill in year t ; $Debt_Due_{it}$ is the debt classified as coming due in year $t+1$ for firm i divided by total assets before capitalized reinstated goodwill at the end of year t ; E_ISSUE_{it} is the net proceeds from common stock issuance in year $t+1$ for firm i divided by the firm's total assets at the end of year t .

5.2 Regression Results

Table 4 presents the results from logit regression. All regression models control for industry and year fixed effects to capture variations across industry and year. Column (1) and column (2) both test for the debt contracting hypothesis, equity contracting hypothesis, political cost hypothesis, and information signalling hypothesis, with column (1) using the level of leverage in year t to proxy for debt contracts and column (2) using the change in the leverage between year $t-1$ and t . Both columns support the leverage hypothesis, but fail to support the other hypotheses. Specifically, the coefficient estimate for LEV is 3.09 in column (1), at less than a 5% level (p -value = 0.01). However, the coefficients on $CLASS$, $SIZE$ and ΔROA are insignificant. Likewise, in column two, the coefficient estimate for ΔLEV is 3.05, at less than a 5% level (p -value = 0.03), whereas the coefficient estimates for the other variables do not reach statistical significance. Bring the results of the two columns together, the findings support the debt contracting hypothesis. We now move to column (3), where we add the financing considerations in the regression model, $Debt_Due$ and E_ISSUE . The coefficient on LEV ($\alpha_1 = 0.70$, p -value = 0.02) and $Debt_Due$ ($\alpha_6 = 1.92$, p -value = 0.08) are significantly positively related to the reinstatement decision. Other variables remain insignificant. Our results suggest that the possibility to renegotiate more debts rather than issuing more equity in the future can affect the firm's decision to reinstate goodwill or not. The results, therefore, reconfirm the debt contracting hypothesis.

6. SENSITIVITY TESTS

We undertake several robustness checks. First, to make the tests more powerful, we use a conditional logistic procedure based on the differences in a common set of explanatory factors between a case and its matched sample. The conditional likelihood for matched pairs is identical to fitting a logistic regression model without intercept to the differences in the original explanatory variables between each case and its control firms

Table 3 Correlation Coefficients of Difference Variables Used in Multivariate Conditional Logit Models

<i>Variables</i>	LEV_{it}	ΔLEV_{it}	ROA_{it+1}	ΔROA_{it+1}	$SIZE_{it}$	$CLASS_{it+1}$	$Debt_Due_{it}$	E_ISSUE_{it}
LEV_{it}	1.00	0.73***	-0.15	-0.11	-0.05	-0.12	0.54***	0.32
ΔLEV_{it}	0.66***	1.00	-0.19	-0.13	-0.35*	-0.10	0.61***	0.43**
ROA_{it+1}	-0.04	-0.14	1.00	0.40**	0.33*	0.45**	-0.53**	-0.17
ΔROA_{it+1}	-0.13	-0.23*	0.51***	1.00	0.05	0.08	-0.43**	-0.14
$SIZE_{it}$	0.18	-0.12	0.30**	0.16	1.00	0.04	-0.42	-0.42
$CLASS_{it+1}$	-0.06	-0.19	0.25*	0.19	0.12	1.00	0.04	-0.04
$Debt_Due_{it}$	0.34**	0.56***	-0.32**	-0.35**	-0.31**	0.14	1.00	0.39*
E_ISSUE_{it}	0.19	0.12	-0.02	-0.05	-0.18	-0.04	0.00	1.00

1. The top half of this table presents Spearman correlation coefficients for the retrospective reinstator sample, and the bottom half for the Pearson correlation coefficients.

2. *, ** and *** respectively indicate significant at the 10%, 5% and 1% level in a two-tailed test.

3. Variable definition: LEV_{it} is financial leverage, defined as the ratio of total debts to total assets for firm at the end of year t ; ΔLEV_{it} is change in financial leverage between year t and $t-1$; ROA_{it+1} is earnings before interests at time $t+1$ divided by average total assets between the period t and $t+1$; ΔROA_{it+1} is the change in return on total asset between year t and $t+1$; $SIZE_{it}$ is the natural log of net sale; $CLASS_{it+1}$ is the number of transactions for firm i during year $t+1$ that could avoid shareholder approval requirements under London Stock Exchange's "Class Test Rules" due to the reinstatement of goodwill in year t ; $Debt_Due_{it}$ is the debt classified as coming due in year $t+1$ for firm i divided by total assets before capitalized reinstated goodwill at the end of year t ; E_ISSUE_{it} is the net proceeds from common stock issuance in year $t+1$ for firm i divided by the firm's total assets at the end of year t .

(Breslow, 1982). This matching design is a way to increase power by removing extraneous effects. Table 5 shows the results using the multivariate conditional logit models. Inferences are robust to the use of a conditional logistic procedure.

Second, we also use ranked data to run logistic models. Results obtained using ranks are relatively free from any undue influence of outliers, and can permit us to do more powerful tests. The results are almost indistinguishable from those using ranked data. Finally, we use different measures for leverage, including both total assets and total equity as scalars. The results are also robust with this specification.

7. CONCLUSIONS AND IMPLICATIONS

This paper explores the determinants that influence a firm's choice to apply retrospective method to reflect the past business combinations when they are not obliged to do so. One of the difficulties to understand the impact of the transition to IFRS is the lack of long timescale and data. The U.K. FRS 10 allowed the exemptions from retrospective method, preparers do not need to reinstate goodwill written off to reserves as a capitalized asset. Since adopting FRS 10 retrospectively is at the discretion of management, it will be interesting to explore whether the option to reinstate goodwill is out of the professional judgment to convey private information to investors, or whether it is associated with firms' incentives to manipulate accounting numbers to reduce the contracting costs (Watts and Zimmerman, 1986). We find that the restatements of goodwill are more associated with firms that have higher debt contracting costs. We do not find evidence that support the information signalling, political cost and equity contracting hypotheses. Our results indicate that firms reinstate goodwill to alleviate the costs of financial distress, and hence possible lawsuits. Firms may also bring back goodwill to increase the possibility of renegotiating new debts in the future.

Our contributions to the literature are three folds. First, we contribute to the debt contracting theory (Watts and Zimmerman, 1986; Duke and

Table 4 Logit Analysis Results of the Reinstatement Decision

$$REINSTATE_{it} = \alpha_0 + \alpha_1 LEV_{it} + \alpha_2 CLASS_{it+1} + \alpha_3 SIZE_{it} + \alpha_4 \Delta ROA_{it+1} + \varepsilon_{it} \dots\dots\dots (1)$$

$$REINSTATE_{it} = \beta_0 + \beta_1 \Delta LEV_{it} + \beta_2 CLASS_{it+1} + \beta_3 SIZE_{it} + \beta_4 \Delta ROA_{it+1} + \delta_{it} \dots\dots\dots (2)$$

$$REINSTATE_{it} = \gamma_0 + \gamma_1 LEV_{it} + \gamma_2 CLASS_{it+1} + \gamma_3 SIZE_{it} + \gamma_4 E_ISSUE_{it} + \gamma_5 Debt_Due_{it} + \eta_{it} \dots\dots\dots (3)$$

	<i>Expected Sign</i>	(1)	(2)	(3)
<i>LEV_{it}</i>	+	3.09** (0.01)		0.70** (0.02)
<i>ΔLEV_{it}</i>	+		3.05** (0.03)	
<i>CLASS_{it+1}</i>	+	0.50 (0.16)	0.57 (0.14)	0.35 (0.28)
<i>SIZE_{it}</i>	?	-0.09 (0.50)	-0.01 (0.92)	0.09 (0.61)
<i>ΔROA_{it+1}</i>	+	-0.85 (0.25)	-0.81 (0.29)	
<i>Debt_Due_{it}</i>	+			1.92* (0.08)
<i>E_ISSUE_{it}</i>	+			3.79 (0.12)
<i>Intercept</i>		-2.11 (-1.60)	-2.35 (-1.74)	-2.71 (-1.55)
<i>Likelihood ratio χ² p-value</i>		0.08	0.19	0.14

1. *, ** and *** respectively indicate significance at the 10%, 5% and 1% level in a two-tailed test. *p*-values are reported in the parentheses.

2. Variable definition: *REINSTATE_{it}* is a dummy variable that is equal to one when a firm has reinstated goodwill (subject firms) and 0 otherwise (comparison sample); *LEV_{it}* is financial leverage, defined as the ratio of total debts to total assets before capitalized reinstated goodwill for firm *i* at the end of year *t*; *ΔLEV_{it}* is change in financial leverage between year *t* and *t*-1; *CLASS_{it+1}* is the number of transactions for firm *i* during year *t*+1 that could avoid shareholder approval requirements under London Stock Exchange class test rules due to the reinstatement of goodwill in year *t*; *SIZE_{it}* is the natural log of net sale; *ΔROA_{it+1}* is change in return on total asset between year *t* and *t*+1. *Debt_Due_{it}* is the debt classified as coming due in year *t*+1 for firm *i* divided by total assets before capitalized reinstated goodwill at the end of year *t*; *E_ISSUE_{it}* is the net proceeds from common stock issuance in year *t*+1 for firm *i* divided by the firm's total assets at the end of year *t*.

Hunt, 1990; Healy and Palepu, 1990; DeFond and Jiambalvo, 1994; Sweeney, 1994) by providing another avenue through which managers can mitigate the debt contracting costs. Our study indicates that firms would take advantage of the leeway during the transition periods of accounting

Table 5 Multivariate Conditional Logit Models of the Reinstatement Decision

$$REINSTATE_{it} = \alpha_0 + \alpha_1 LEV_{it} + \alpha_2 CLASS_{it+1} + \alpha_3 SIZE_{it} + \alpha_4 \Delta ROA_{it+1} + \varepsilon_{it} \dots\dots\dots(1)$$

$$REINSTATE_{it} = \beta_0 + \beta_1 \Delta LEV_{it} + \beta_2 CLASS_{it+1} + \beta_3 SIZE_{it} + \beta_4 \Delta ROA_{it+1} + \delta_{it} \dots\dots\dots(2)$$

$$REINSTATE_{it} = \gamma_0 + \gamma_1 LEV_{it} + \gamma_2 CLASS_{it+1} + \gamma_3 SIZE_{it} + \gamma_4 E_ISSUE_{it} + \gamma_5 Debt_Due_{it} + \eta_{it} \dots\dots\dots(3)$$

<i>Variables</i>	<i>Expected Sign</i>	(1)	(2)	(3)
<i>LEV_{it}</i>	+	1.69 (0.22)		1.09 (0.34)
ΔLEV_{it}	+		5.25** (0.04)	
<i>CLASS_{it+1}</i>	+	1.67 (0.31)	1.28 (0.37)	0.51 (0.32)
<i>SIZE_{it}</i>	?	0.25 (0.29)	0.21 (0.33)	0.25 (0.31)
ΔROA_{it+1}	+	-4.17* (0.09)	-0.02 (0.45)	
<i>Debt_Due_{it}</i>	+			1.90** (0.06)
<i>E_ISSUE_{it}</i>	+			3.64 (0.24)
<i>Intercept</i>		0.04 (0.18)	0.03 (0.16)	0.46 (0.29)
<i>Likelihood ratio χ^2 p-value</i>		0.08	0.19	0.14

1. *, ** and *** respectively indicate significance at the 10%, 5% and 1% level in a two-tailed test. *p*-values are reported in the parentheses.

2. Variable definition: *REINSTATE_{it}* is a dummy variable that is equal to one when a firm has reinstated goodwill (subject firms) and 0 otherwise (comparison sample); *LEV_{it}* is financial leverage, defined as the ratio of total debts to total assets before capitalized reinstated goodwill for firm at the end of year *t*; ΔLEV_{it} is change in financial leverage between year *t* and *t*-1; *CLASS_{it+1}* is the number of transactions for firm *i* during year *t*+1 that could avoid shareholder approval requirements under London Stock Exchange class test rules due to the reinstatement of goodwill in year *t*; *SIZE_{it}* is the natural log of net sale; ΔROA_{it+1} is change in return on total asset between year *t* and *t*+1. *Debt_Due_{it}* is the debt classified as coming due in year *t*+1 for firm *i* divided by total assets before capitalized reinstated goodwill at the end of year *t*; *E_ISSUE_{it}* is the net proceeds from common stock issuance in year *t*+1 for firm *i* divided by the firm's total assets at the end of year *t*.

standards. In the context of business combinations, we find that only when firms that need to manage the value of net assets to avoid debt contracting costs would reinstate business combinations. Second, we contribute to the accounting standard literature (Harris and Muller III, 1999; Leuz and

Verrecchia, 2000; Barth et al., 2008) by examining the accounting choices during the transitional period such as IFRS 1 on whether retrospective restatement of past business combinations should be prohibited, permitted or required (IFRS 1, BC32-34). Our study suggests that if retrospective application of business combination is not used to achieve better value relevance and comparability across periods, the optional exemption should be viewed cautiously as the potential misuse can jeopardize the reliability of financial statements. Third, our study provides important implications for Taiwanese firms, where the adoption of IFRS in 2013 might lead to an enormous impact on the financial reporting, in particular, the impact for the first-year adoption. For majority of accounting standards, companies have to restate their previous year's financial statements according to IFRS as if they have applied IFRS since inceptions. However, for some of the standards that IFRS provides the option to employ retrospective application, interpreting the financial statements should be viewed cautiously arising from optional retrospective applications.

While we view the U.K. FRS 10 as providing a unique and attractive test of the "optional exemptions" in IFRS 1, we are cautious in generalizing our inferences from business combinations to other optional exemptions. Moreover, to the extent that the optional exemptions under FRS 10 do not truly represent a context in which there are large bankruptcy costs to be avoided, our inferences regarding to the debt contracting hypothesis should be viewed with caution.

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