

Example of earnings management

- **taken from Kamp, Issues in Accounting Education, Nov 2002.**
- **Analyst downgrades from Hold-Buy to Hold after accounting treatment is uncovered**

- **Basics**
- **WKL, a Dutch publisher**
- **acquired CCH in 1995 for 3000 (NLGm)**
- **goodwill = 1945, book value of assets=1055**
- **goodwill capitalised, amortised over 40 years (ie 48.625 pa)**
- **after the takeover, WKL found that some 200 of restructuring needed to be done**

- **key issue is the treatment of the restructuring**

Balance sheet

<ul style="list-style-type: none"> • ASSETS • Bank -3000 <li style="padding-left: 100px;">{-50} • Assets 1055 • Goodwill 1945 <li style="padding-left: 20px;">(amortised to P&L over 40 yrs) • Restructuring <li style="padding-left: 20px;">goodwill +200 <li style="padding-left: 100px;">-10 	<ul style="list-style-type: none"> • LIABILITIES • Provision +200 <li style="padding-left: 100px;">[-50] • EQUITY • Initial capital • Reserves • Current P&L -10 <li style="padding-left: 100px;">{-50} <li style="padding-left: 100px;">[+50]
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Provision released to P&L as R expenditure undertaken: 50, 50,50,17,17,16. The release [-50] will offset the charge to P&L {-50}.

However, R goodwill also amortised to P&L, but over 20 years, ie 10 pa!

A method of spreading out expenditure.

- **US GAAP requires restructuring expenses to be charged to the P&L in the year that it occurs**
- **at the time, Dutch GAAP did not prohibit the provision treatment, but analysts were less than impressed.**
- **even better UK approach prior to new Financial Reporting Standard (FRS10)**
 - in dividing purchase price between assets and goodwill
 - include "restructuring and future losses" in goodwill
 - then write off goodwill to reserves!
 - no effect of losses & restructuring on P&L
 - as expenditure undertaken or losses incurred (-ve for P&L) transfer made from provisions (+ve for P&L)

- **Amortisation of goodwill?**
- **IAS 22**
capitalise and amortise goodwill over useful life, presumed to be 20 years
- **US GAAP**
capitalise, but subject to impairment

impairment test needs to be undertaken if asset carrying amount exceeds undiscounted cash flows from the asset

- note that using undiscounted cash flows reduces the chance that impairment will be triggered
- should be *discounted* cash flows