

**THE NEW U.S. STANDARDS
ON ACCOUNTING FOR GOODWILL:
AN EXPLORATORY STUDY
WITH REFERENCE TO EUROPEAN COMPANIES**

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Abstract

In July 2001 the Financial Accounting Standards Board (FASB) issued two new standards, the Statement of Financial Accounting Standard (SFAS) no. 141 on Business Combinations and the Statement no. 142 on Goodwill and Other Intangible Assets.

Before SFAS 141, business combinations were to be accounted for using one of the two methods prescribed by the APB Opinion no. 16, that allowed the use of the pooling-of-interests method or the use of the purchase method. Even if the pooling-of-interests method was allowed only when some criteria were met, this possibility impaired the comparability of financial statements and other accounting documents disclosed by different companies. Therefore, by issuing SFAS 141, FASB imposed the application only of the purchase method, prohibiting the use of the pooling-of-interests method.

SFAS 142 has been issued to supersede APB Opinion no. 17 on Intangibles. It requires a much more refined breakdown of goodwill into its component intangibles as well as an annual impairment test on the latter's values. Indeed, goodwill and intangible assets acquired before June 30, 2001 were considered to have a finite life and had to be amortised over their useful life up to 40 years. After the issuance of the new standard, goodwill and some intangible assets with indefinite useful lives will still be capitalised but no longer amortized; instead they will be annually tested for impairment. The standard also requires an increased disclosure on goodwill and intangible assets that was not previously required.

The aim of this study is to analyse the impact that these regulatory changes may produce on net income and shareholders' equity of European companies, that for the first time in 2002 have to prepare their consolidated accounts according to these two new standards, due to the requirement imposed by the SEC on foreign registrants to reconcile their annual accounts with US Generally Accepted Accounting Principles (GAAP).

The relevance of this topic is linked to the prospective adoption by the International Accounting Standards Board (IASB) of the US rules. As a consequence of the recent EU regulation requiring the use of International Accounting Standards by the listed European companies for their consolidated accounts from 2005 onwards, the above US rules will then become extended also to the EU context.

The empirical analysis will consider the European companies listed on Nyse and Nasdaq producing a reconciliation between their domestic and the US-based financial results. Therefore, by analysing the Form 20-F prepared by companies, it will be possible to formulate some consideration about the impact of the implementation of these new accounting principles on European companies' financial results. Some further indications about the distance between domestic and American accounting standards may be given.

A further aim of the paper is to analyse the amount of disclosure released by European companies with reference to the new treatment of goodwill and its component parts.

1. INTRODUCTION: SFAS 141 AND 142 AS THE CULMINATION OF THE FASB BUSINESS COMBINATION PROCESS

In recent years intangible assets have notably increased their importance within companies and this produced the need of a better disclosure about this kind of resource. At the same time, last years have been characterised by a strong wave of mergers and acquisitions that has sharpened the problem of the accounting of intangibles, which constitute an increasing portion of the assets acquired in this kind of transactions.

Several institutions, especially accounting institutions, moved toward the solution of this problem, changing rules at the base. Definitely the issuing of Statement of Financial Accounting Standard (SFAS) nos. 141 Business Combinations and 142 Goodwill and Other Intangible Assets in July 2001 marked an important step in this direction and after Financial Accounting Standards Board (FASB) several institutions followed its tracks. These Statements are among the most significant pronouncements issued by the FASB in many years and reflect the culmination of a process begun in the second half of 90s about business combinations.

The aim of the FASB work was to increase reliability of financial data and comparability of the financial statements disclosed by companies. The starting point was the possibility to account for business combination using the purchase method or the pooling-of-interests method (nevertheless the use of the second one was permitted only when certain criteria were met). Consequently, similar transactions might have been recorded in two different ways, making the comparability of financial statements difficult. Thus the first aim was the abolition of the alternative use of the two methods: FASB decided business combination to be accounted for using only the purchase method, prohibiting the use of the pooling-of-interests. Another important step was to revise requirements contained in APB Opinion nos. 16 and 17 about the identification and the recognition of intangible assets and their accounting apart from goodwill, enhancing consistency in the application of the standards. Finally, FASB decided that useful lives of certain intangible assets could have been indefinite and that amortisation of those assets would have not be representationally faithful. These are the main three points on which the Exposure Draft issued in February 2001 for illustrating the new accounting model was about. In response, FASB received several comment letters, which brought some changes about:

- the level at which to measure goodwill impairment. The FASB revised the definition of reporting unit (the level within the consolidated business at which goodwill impairment is measured) to a higher level, which reduced the potential number of reporting units and the extent of goodwill impairment testing;
- the timing and the mechanism of the impairment test. SFAS 142 requires an at least annually impairment test instead of the application of the indicator-based approach proposed in February 2001 Exposure Draft. Furthermore, a two-step approach have been introduced; and
- effective date. The ED required the immediate adoption of both SFAS after their final issuing. Instead, general rules are that SFAS 141 is effective for business combination initiated after July 1, 2001 and SFAS 142 for years beginning after December 15, 2001.

In July 2001, with an unanimous approval, FASB issued SFAS no. 141 Business Combinations and SFAS no. 142 Goodwill and Other Intangible Assets, which superseded APB Opinion 16 and 17 respectively. The extent of the consequences of these two accounting standards is wide, as they brought strong innovation in accounting for intangibles, especially goodwill, acquired singly, in group or in a business combination. They are the answer to the need of a better disclosure about this resource and of an increased comparability of accounting documents. Through their application reflecting investments made in an acquired entity has improved, as purchase method records transactions basing on the exchange value, and disclosure about the operation made had increased and this can help to better understand the economic effect of the transaction and to better assess the future profitability of the company and future cash flows. In general, SFAS 141 and 142 produced a

greater reliability of financial results, in compliance with the concept of faithfulness in the representation of financial results contained in FASB Concepts Statement no. 2 Qualitative Characteristics of Accounting Information .

The aim of this study is to analyse the way European companies listed on US financial markets (Nyse and Nasdaq) reacted to the issuing of SFAS 141 and 142 and, whenever they already adopt them, to measure the impact of their application on net income and shareholders equity.

The importance of this topic is linked to the relevance of US Gaap in Europe. Actually European companies listed in the USA prepare their consolidated accounts in compliance with US Gaap or present a reconciliation between American accounting principles and local Gaap, as well as requested by the Securities and Exchange Commission (SEC) to foreign registrants listing their stocks on Nyse and Nasdaq. Thus in 2002 European companies had to face for the first time the application of the two new SFAS. Moreover, the importance of this issue is linked to recent changes in EU regulation, which prescribes European listed companies to prepare their consolidated accounts in accordance to International Accounting Standards (IAS) from 2005 onwards. As in last years a progressive alignment between US Gaap and IAS has begun, it is reasonable to think that changes in American accounting practices might influence accounting of European companies.

At first an analysis of the two SFAS will be proposed. It will be given a general overview of their content and, after the analysis of the main difference between them and the principles they supersede, the main innovation points will be highlighted. As it is reasonable to think they will have a strong impact on accounting practices, some suggestions for companies applying them will be given.

Then the empirical analysis will be presented. It is based on Form 20-F released by companies: at first it will be conducted a qualitative study in order to assess the behaviour of the analysed companies in respect of SFAS 141 and 142. Then, comparability indexes, both global and partial, will be calculated to measure the quantitative effect of the two SFAS on net income and shareholders equity.

The last section will be dedicated to conclusion. Findings about examined issues will be presented, giving some interpretations and comments. Some further suggestion for a future development of this study will be given.

2. THE PRESENTATION OF SFAS 141 AND 142

2.1 An overview of SFAS 141 and SFAS 142

2.1.1 SFAS 141 Business Combinations

Statement no. 141 has been issued by FASB in order to bring relevant changes in the method of accounting for business combinations and in the classification of intangibles and in their recognition apart from goodwill. On the one hand, it prescribes this kind of transactions to be accounted for only by purchase method; on the other hand it gives criteria that intangibles must respect for their recognition apart from goodwill.

This statement supersedes APB Opinion no. 16 Business Combination issued in 1970 and amends or supersedes a number of its subsequent interpretations. APB Opinions allowed companies to record business combinations using one of the two prescribed methods: the purchase method or the pooling-of-interests method. Even if the use of the pooling-of-interests method was permitted only if certain criteria were met, the possibility to account for similar transactions in different manner reduced the comparability of financial statements disclosed by companies.

Beyond this aspect, other issues have been revised from the issuing of SFAS 141. Giving a summary of the differences between Statement no. 141 and APB Opinion 16, it results that:

- SFAS prescribes only one method of accounting for business combinations, that is the purchase method. This approach is totally different from the one followed in APB Opinion, as now all business combination are treated as acquisitions and their recording is based on exchange value;
- SFAS identifies criteria that intangibles have to meet for their recognition apart from goodwill. While, in accordance with APB Opinion, intangible could be separately recognised when they could be named or identified, SFAS prescribes that intangibles meet the contractual-legal or the separability criterion;
- SFAS requires a more complete disclosure about business combinations than required by APB Opinion 16.

In spite of important changes introduced, many of the previous prescription remained the same, like criteria followed by companies to determine the cost of the acquired entity and to allocate the cost to assets acquired and liabilities assumed, the accounting for contingent consideration and preacquisition contingencies.

As pointed out previously, according to new FASB statement, all business combination are to be accounted for only using the purchase method and not the pooling-of-interests. In this case, this kind of transaction are treated like acquisitions: an acquirer entity is identified and a goodwill value emerges as the excess of the cost over the net amounts of assets acquired and liabilities assumed.

Another important innovation introduced by SFAS 141 regards the separate recognition of intangible assets apart from goodwill. This is the most important change in allocating the cost of the business combination. It prescribes that intangible assets have to meet two criteria for their separate recognition, otherwise their value must be included in goodwill. These criteria are:

1) the contractual-legal criteria. The intangible asset has to arise from a contract or a legal rights, regardless if that contract or that right can be transferred separately from the entity acquired or from other rights and obligations.

2) the separability criteria. If the intangible assets does not arise from a contract or from a legal right, it can be recognised apart from goodwill only if it is separable. This means that it can be divided or separated by the acquired entity and can be sold, exchanged, transferred or rented. Even when an intangible asset cannot be sold, transferred, exchanged, rented individually, it is to be considered separable if it can be part of a transaction together with a related contract, asset or liability.

To help companies to better allocate the cost of the business combination, SFAS 141 gives a list of examples of intangible asset that meet these two criteria and are therefore accounted for as asset apart from goodwill. This guidance identifies five categories of intangible assets:

- Market-related intangible assets;
- Customer-related intangible assets;
- Artistic-related intangible assets;
- Contract-related intangible assets; and
- Technology-related intangible assets.

This is not an exhaustive classification and inside each category many intangibles can be included. As for amortisation of these intangibles and impairment methods, prescription are given by SFAS 142.

It is interesting to point out that the value of the assembled workforce of at-will¹ employees acquired in a business combination does not meet the two prescribed criteria for the separate recognition and should therefore be included in the amount recorded as goodwill. This is based on

¹ At will employees refers to those employees that are not subject to a contractual employment agreement.

the FASB's view of the limitations in valuing the intellectual capital that underlies the values of an assembled workforce².

Finally SFAS 141 requires companies to produce a more complete disclosure about the completed business combination. Prescriptions regard both information to disclose in the annual financial statement and disclosure to be produced in the interim report. Beyond the information that a company has to produce in the period in which a material business combination is completed (general information about the operation), other several cases are indicated:

- a. when the amounts assigned to goodwill or to other intangible assets are relevant in relation to the total cost of the operation during the period in which a material business combination is completed: SFAS 141 requires specific information for goodwill, intangible assets subject to amortisation, intangible assets not subject to amortisation (these information, together with general information about the business combination, are to be disclosed also when the operation is completed during the current year up to the date of the most recent interim balance sheet presented);
- b. when a series of intangibles are not individually immaterial but material in the aggregate;
- c. when the company is a public business enterprise, supplemental information are to be disclosed in the notes to the financial statement on a pro-forma basis for the period in which a material business combination occurs;
- d. when an extraordinary gain due to the business combination occurs, information required by APB Opinion 30 are to be produced;
- e. when the allocation of the purchase price is preliminary and when contingent consideration are based on future earnings, companies have to produce the information required by the SEC.

Regarding to the information to be disclosed in the interim report, companies must provide it when the business combination is completed during the year up to the date of the nearest interim report. SFAS 141 requires the disclosure to be given in the period the business combination is completed (general information, results on a pro-forma basis regarding revenues, earnings, etc) and the disclosure required by the SEC when the allocation of the purchase price is preliminary and when contingent consideration are based on future earnings.

Provisions of SFAS 141 apply to all business combination initiated after June 30, 2001 and to all business combination accounted for by the purchase method whose acquisition date is July 1, 2001, or later (these prescriptions do not apply to business combination between two or more mutual enterprises) It is therefore important to give a definition for initiated : SFAS refers to the definition given by APB Opinion 16, for which a business combination is considered initiated at the date when the main terms of the plan are publicly released or at the date when stockholders are notified in writing with the exchange offer.

Moreover some transition provisions have been given for the accounting of business combinations by the purchase method when the acquisition date is before July 1, 2001. In this case, the carrying amount of acquired intangible assets that do not meet the criteria for the separate recognition apart from goodwill must be reclassified and included in the goodwill value as of the date in which SFAS 142 is applied in its entirety. Furthermore, the carrying value of intangibles meeting the contractual-legal and the separability criteria that were included in goodwill must be reclassified as of the date in which SFAS 142 is applied in its entirety.

² As it can be showed by the empirical analysis presented in the third paragraph, the workforce is the more reclassified item after the application of SFAS 141 and 142.

2.1.2 SFAS 142 Goodwill and Other Intangible Assets

Statement no. 142 has been issued together with SFAS 141 in July 2001 in order to introduce some changes in the treatment of goodwill and other intangible assets. These changes affect their accounting also when they are acquired for effect of a business combinations. The innovation introduced regard especially the amortisation of goodwill and the accounting of other intangible assets, for which SFAS prescribes a division between intangibles with finite and indefinite life.

SFAS 142 supersedes APB Opinion no. 17 Intangible Assets issued in 1970, with the exclusion of the method of accounting for intangibles internally developed and of the requirement to expense research and development costs at the date of acquisition. The approach introduced by SFAS 142 is deeply different from the one previously adopted, as goodwill and some intangible assets (with indefinite useful life) will cease to be amortised: the consequence of this treatment will be that their values will not decrease constantly. This may produce a greater volatility of the net income, as impairment losses might occur irregularly and for different amounts. Giving a summary of the differences between SFAS 142 and APB Opinion 17, it results that:

- SFAS adopts a more aggregate approach. It better recognises synergies within the entity, as the accounting for goodwill is based on reporting units;
- SFAS no longer presumes that goodwill and other intangible assets have a finite useful life (wasting assets) and no longer requires their amortisation up to 40 years. SFAS recognises that goodwill and some assets may have an indefinite useful life and that their amortisation does not reflect the economic situation. For this reason, an impairment test is required to be performed at least annually to assess their value;
- SFAS provides specific guidance for the goodwill impairment test, while APB Opinion provided little guidance about it. This produced a lower reliability of the information, also because of the lack of comparability in its accounting. At the same time, specific guidance is provided for intangibles not subject to amortisation: like goodwill, they will be subject to an impairment test to verify their amount;
- SFAS 142 requires a more complete disclosure for goodwill and other intangible assets subsequent to their initial recognition.

Most important changes introduced by Statement 142 regard goodwill and other intangibles. As prescribed, goodwill will cease to be amortized: it will be tested for impairment at least annually at the reporting unit level. First of all, it is necessary to define what is a reporting unit. Then it is necessary to define the mechanism used for the impairment test.

According to the definition contained in SFAS 131 Disclosure about Segment of an Enterprise and Related Information, a reporting unit is the same level as or one level below an operating segment³. Thus the allocation of the goodwill to each reporting unit at the acquisition date is an operation that will become very important for testing goodwill for impairment. Goodwill must be assigned to the reporting unit that may benefit of synergies deriving from the aggregation. If it is to be allocate to more than one reporting units, the allocation must be reasonable, supportable and consistent, as required by the Statement.

As for the mechanism of this test, SFAS prescribes a two-steps approach. The first step consists in comparing the carrying amount of the reporting unit, including the goodwill, to its fair value to assess whether there is a need for impairment. At this point, it is important to give a definition of fair value. It is the value at which a reporting unit can be exchanged⁴. If the fair value exceeds the

³ SFAS 131 defines an operating segment as a component of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

⁴ Statement of Financial Accounting Concept (SFAC) no. 7 define the fair value as the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

carrying amount, goodwill is considered not impaired and the second step is unnecessary. If the fair value is lower than the carrying value, the second step of the test shall be performed for measuring the goodwill impairment, if any.

Second step consists in comparing the implied fair value of goodwill of one reporting unit to its carrying value. Implied fair value is the excess of the fair value of the reporting unit over the amount assigned to its net assets and liabilities: it is calculated deducting by the reporting unit fair value the fair value of all assets (both tangible and intangible) assigned to the reporting unit. If it emerges that carrying value is higher than the implied fair value, an impairment loss should be recognised in an amount equal to that difference (the impairment loss cannot exceed the carrying value of the goodwill). After its recognition, the adjusted carrying value of goodwill shall be its new accounting bases. Moreover, subsequent reversal of a previously recognised goodwill impairment loss is prohibited once the measurement is completed. Regarding to its presentation in the financial statement, impairment loss should be presented as a separate line in the operating section of the income statement.

As pointed out before, companies shall perform the impairment test at least annually, or when circumstances or events occur and indicate that an impairment of the fair value of the reporting unit is more likely than not. The measurement can be performed at any time during the year, provided that it is performed at the same time every year.

Another innovation introduced by SFAS 142 regards the different treatment of intangibles with a finite life and intangibles with an indefinite life. Considering that the useful life corresponds to the period in which an asset contributes directly or indirectly to future cash flows, intangibles with a finite useful life will continue to be amortised over their useful life in a manner that reflects the pattern in which economic benefits are consumed. When the pattern cannot be reliably determined, a straight-line amortisation shall be used. An important innovation introduced by this Statement in respect of APB 17 prescriptions is that it does not impose a temporal limit for the amortisation: APB 17 prescribed that intangibles had to be amortised up to 40 years, while SFAS prescribes that amortisation must continue for the useful life.

Regarding to the treatment of intangibles with indefinite useful life, it is similar to the treatment of goodwill. Also this kind of intangible assets will no longer be amortised but subject to an impairment test, but performed in a different manner from the goodwill. In this case, it consists in comparing the fair value of the asset to its carrying value. If the carrying amount is higher than the fair value, the company must recognise an impairment loss equal to this excess.

As well as the SFAS 141, Statement no. 142 requires a more complete disclosure about goodwill and intangible assets. It gives guidance about information that companies have to disclose. There are some information that have to be presented in every period for which financial statement position is prepared and regard intangibles subject to amortisation, intangibles not subject to amortisation and changes in the carrying value of goodwill. Other information have to be disclosed when only a portion of the goodwill is allocated to the reporting unit and also when there is a recognised impairment loss that also includes intangibles not subject to amortisation. Finally, company are required to disclose particular information in the acquisition period for intangibles acquired either individually or in group that do not constitute a business.

All prescriptions of SFAS 142 will be effective for fiscal years beginning after December 15, 2001. An early application is allowed for companies whose fiscal year begins after March 15, 2001, provided that the first interim report has not been previously issued. Some prescription already apply to goodwill and other intangible assets acquired after June 30, 2001, even if the Statement has not been applied in its entirety.

FASB also prescribes some transition provisions for goodwill and other intangibles acquired in a business combination whose acquisition date is before July 1, 2001 that were accounted for by the

purchase method: these provisions regard the need to reclassify as of the date in which SFAS 142 is applied in its entirety the carrying value of intangibles that cannot be recognised as assets apart from goodwill, as well as the carrying amount of recognised intangibles meeting criteria prescribed by SFAS 141 and the carrying amount of recognised unidentified intangibles that were included in goodwill.

Finally, some particular prescriptions for goodwill and intangible assets acquired after June 30, 2001, for goodwill and intangible assets previously recognised and for the equity method goodwill are given.

2.2 The implementation of the Statements

The innovation introduced by the SFAS nos. 141 and 142 will certainly bring companies to strongly engage in applying in the best way these two new SFAS.

Referring to the contents of the two Statements, one of the first steps companies will make is the analysis of the structure of their assets, in order to identify intangible assets that meet legal-contractual and separability criteria prescribed by SFAS 141 for the separate recognition apart from goodwill and intangible asset that must be included in goodwill as they do not meet these requirements. This recognising operation also regards those intangibles that were previously aggregated in the balance sheet as a unique item with goodwill (e.g. because the amortisation period was the same): SFAS 141 requires separate indication in the financial statement. Moreover the negative goodwill has to be identified because any existing negative goodwill shall be recorded as the cumulative effect of a change in accounting.

After that, it is necessary the assessment of the useful life of intangible assets as their treatment depends upon this aspect. Companies are therefore required to take into consideration several factors to define the period in which assets release their economic effects. Among these factors:

- legal, regulatory, or contractual provision that limit the maximum useful life or enable the renewal or the extension of the contractual life without substantial costs;
- the effect of obsolescence, demand, competition, and other economic factors and the level of maintenance expenditure;
- the expected use of the assets by companies or the useful life of some assets that may influence the useful life.

As for the treatment of goodwill, it is first necessary to define reporting units to which goodwill must be allocated, since goodwill impairment test is to be performed at this level. Companies have therefore to evaluate if it is appropriate to use the operating segment or if it is necessary to refer to the level below the operating segment. After that, goodwill is to be allocated to each reporting unit in the supportable and reasonable manner, taking into consideration the entities that benefit from the synergies deriving from the aggregation.

In order to perform the impairment test, it is necessary to determine the fair value. It is a very delicate step because results of the impairment test depends upon this value. SFAS 142 prescribes that the best evidence of the fair value is the quoted market price and suggests companies to use it, if it is available. If this is not possible, the best information shall be used, also referring to prices for similar assets and liabilities or to other evaluation techniques, e.g. cash flows or multiple techniques.

After the consideration on the main new aspects of SFAS 141 and 142, a summary of the key steps that companies will need to take for implementing these two principles has been given and a suggestion is that companies prepare for these steps as soon as possible.

3. RESEARCH AND METHODOLOGY

3.1 The sample

The analysis in this paper takes into consideration European companies listed on US financial markets (Nyse and Nasdaq) on December 31, 2002, whose fiscal year ends in 2002 before December 31.

The choice to adopt a closing-date approach and not a fiscal-year approach has been determined by the availability of data. Most companies fiscal year ends December 31 and at the date of this study it would not have been possible to collect all Form 20-F (or Annual Report).⁵ This means that in some cases the fiscal 2001 have been considered and in some cases fiscal 2002 has been took into consideration.

The possibility of leading this study has been given by the fulfilling of Securities and Exchange Commission (SEC) requirement. SEC prescribes non-US companies listing their stocks on US stock exchanges to present their consolidated accounts complying with US Gaap or to prepare a reconciliation between US Gaap and national accounting principles.

Data have been collected consulting web sites of Nyse and Nasdaq e the sample has been formed by 52 companies, 24 listed on Nyse and 29 listed on Nasdaq (Carlton Communication is listed on both stock exchanges). These companies belong to 7 different countries: France, Germany, United Kingdom, Ireland, Luxemburg, The Netherlands, Switzerland. Previously two companies have been excluded from the sample because they are not European companies (Appendix A).

3.2 Alternative behaviour of the analysed companies

In analysing the accounting behaviour of the companies composing the sample of this study, it has been found that they comply with the SEC requirements in different manner.

Companies has been divided into three categories:

1. Fully compatible accounts: these companies prepare their consolidated accounts in accordance with US Gaap, that fully comply with the national accounting rules. This is the case of the Swiss company analysed.
2. Only non-national accounts: these companies do not prepare their consolidate accounts in accordance with their domestic accounting standards but prepare them complying with US Gaap. In this category also companies preparing Forms 10-K and 10-Q have been included. In this case it is not possible to assess the qualitative difference and the distance between national and non-national accounting rules. Some French, German, UK, Irish and Dutch companies (for a total of nine companies) belong to this group.
3. Reconciliation provided: companies belonging to this group provide a reconciliation between national accounting standards and US Gaap. Only for this companies it is therefore possible to measure the distance between domestic and American accounting rules by calculating the comparability indexes. Only thirteen UK and Irish companies belong to this category.

Only for companies classified into the third category comparability indexes, both global and partial, have been calculated. Nevertheless other companies have been used for the qualitative analysis.

⁵ The label 2002 refers to fiscal years ending between July 1, 2002 and June 30, 2003, therefore most financial documents are not yet available.

Table 3.1 Alternative accounting behaviour of the analysed companies

| | COMPANIES |
|-------------------------------------|--|
| U.S. GAAP | |
| • <i>Fully compatible accounts</i> | Logitech (Switzerland) <i>Total = 1</i> |
| • <i>Only non-national accounts</i> | Infovista (France); Lion Bioscience, Siemens (Germany); Futuremedia, Galen Holdings, Professional Staff (UK); ICON, Trintech (Ireland); Metron (The Netherlands) <i>Total = 9</i> |
| • <i>Reconciliation provided</i> | British Energy, Cable & Wireless, Diageo, Eidos, Imperial Tobacco Group, National Grid Transco, Premier Farnell, Scottish Power, The Boc Group, Tomkins, Vodafone Group (UK); Ryanair Holdings, The Governor and Company of the Bank of Ireland (Ireland) <i>Total = 13</i> |
| TOTAL U.S. GAAP | Total = 23 |

Source: elaboration of the writer.

3.3 Methodology

The aim of this paper is to analyse the state of the implementation of SFAS 141 and 142, which became effective respectively for business combination initiated after June 30, 2001 or business combinations accounted for using the purchase method completed after July 1, 2001 and for fiscal year beginning after December 15, 2001, even if transitional provisions apply to goodwill and intangible assets acquired in a business combination for which the acquisition date was before July 1, 2001, that were accounted for by the purchase method. When companies already apply these Statements, the distance between domestic accounting principles and US Gaap will be measured.

First a qualitative analysis has been conducted. Form 20-F (or the Annual Report) have been analysed in the section dedicated to accounting policy or in the notes to the accounts, in order to verify which principles companies adopt to account for business combinations and goodwill and intangible assets. This study allows to check whether new SFAS are already applied by companies, the manner they are applied or the way companies are preparing to implement them.

When the qualitative analysis shows that companies comply with at least one of the two SFAS, comparability indexes have been calculated, in order to measure the distance between the two sets of accounting principles⁶.

At first, the global distance has been measured, by calculating the global comparability index, that is:

$$1 - \frac{\text{US value} - \text{non-US value}}{|\text{US value}|}$$

When the index assumes values greater than 1, the value deriving by the application of national accounting principles is higher than the one calculated in respect of US Gaap. Viceversa, when the index assumes values lower than 1, the application of national Gaap bring to values lower than the

⁶ Companies producing a reconciliation between local and US Gaap have been considered. From the analysis it emerged that it has been prepared only by UK and Irish companies. Comparability indexes measure therefore the distance between US Gaap and UK and Irish Gaap.

values calculated by applying American accounting principles. If the index is equal to 1, there is compatibility between the two sets of accounting principles.

Even if this index has been widely used in literature it is not without some methodological limits. For instance, it has been pointed out that it tends to indeterminism when the non-national value tends to zero.

In order to quantify the impact of the adjustments related to goodwill and to its amortisation on financial results, a partial comparability index has been calculated, that is:

$$1 - \frac{\text{partial adjustment value}}{|\text{US value}|}$$

As well as the global index, the partial index revolves around the value of 1. If it assumes values greater than 1, national-based results are higher than American-based and viceversa.

In both cases, outliers values have been excluded from the analysis, as their inclusion could have produced misleading results. Outliers have been assumed to occur when the values are higher than +4 or lower than -2, which corresponds to a differences, in absolute value, of 300%.

Indexes have been calculated for the main financial results (net income and shareholders equity) and have been used as benchmark first US Gaap and then national accounting principles. Regarding to the global comparability index, it has also been calculated for ROE. This measure sums up the two main financial results, as it is given by their ratio (net income/shareholders equity). It plays such a role of stabilisation, that it is able to express the global extent of the comparability between two different sets of accounting principles. In the second case, index continues to revolve around the value of 1 but if it assumes values lower than 1 results obtained by the application of US Gaap are lower than values obtained complying with national accounting principles and viceversa. There is an inversion in the meaning of the values assumed by the comparability index.

Unfortunately the low numerosness of the sample has not allowed to apply statistical test to confirm findings from the calculation of the comparability indexes.

4. FINDINGS

4.1 The present application of SFAS 141 and 142: the state of the art

The analysis shows that, excluding companies whose Form 20-F (or Annual Report) is not yet available or the ones not disclosing about the application of SFAS 141 and 142, at the time of this study 23 companies of the 52 sample companies prepare their consolidated accounts in accordance with at least one of the two new principles (see Table 4.1). Of these 23 companies, only 10 apply both of them.

Some of these companies had business combination in 2002; these transactions, according to provisions of SFAS 141, have been recorded using the purchase method, by which a goodwill has been recognised. Furthermore, by implementing this new standard, companies had to reclassify their intangible assets, in respect of the criteria prescribed by the Statement for their separate recognition apart from goodwill or the inclusion of their value in the goodwill. From the analysis emerged that several companies had to reclassify the workforce into goodwill.

In respect of SFAS 142 and its implementation, companies already applying it ceased to amortise goodwill and conducted a goodwill impairment test at the date of the adoption: the eventual impairment loss has been reclassified as an effect of a change in accounting policy. The immediate effect of the application of this Statement is an increase in net income, due to the decrease in amortisation costs. Most companies valued this effect as not material. As for impairment test, most of the companies have already completed the two prescribed steps and in most cases losses has not been recorded.

Regarding to the behaviour of companies not already applying SFAS 141 and 142, analysis shows that most companies are preparing for their future adoption, that will be completed in fiscal 2002, and are testing goodwill value. These companies are also assessing their intangible asset structure in compliance with criteria indicated in SFAS 141 for the separate recognition of intangibles apart from goodwill. Whilst there is not punctual disclosure about the reclassification, the general tendency is that there would not be the need to impair goodwill, even if in some cases management declare not to be able to value the effect of the impairment of financial position of the company. Instead the non-amortisation of goodwill and other intangibles with indefinite useful lives will have more certain consequence: this prescription will have the effect of increasing net income, because of the reduction of the amortisation charge.

This qualitative analysis has therefore shown that about the half of the analysed companies already apply at least one of the two Statements and that other companies are preparing for their future implementation, even if it will take some other time to have more punctual results about the consequences of this new US accounting standards.

Table 4.1 Companies adopting SFAS 141 and 142

| Company | Country |
|---|-----------------|
| 1 Infovista | France |
| 2 Lion Bioscience | Germany |
| 3 Siemens | Germany |
| 4 ICON | Ireland |
| 5 Ryanair Holdings | Ireland |
| 6 The Governor and Company of the Bank of Ireland | Ireland |
| 7 Trintech Group | Ireland |
| 8 Logitech | Switzerland |
| 9 Metron Technology | The Netherlands |
| 10 British Energy | UK |
| 11 Cable & Wireless | UK |
| 12 Diageo | UK |
| 13 Eidos | UK |
| 14 Futuremedia | UK |
| 15 Galen Holdings | UK |
| 16 Imperial Tobacco Group | UK |
| 17 National Grid Transco | UK |
| 18 Premier Farnell | UK |
| 19 Professional Staff | UK |
| 20 Scottish Power | UK |
| 21 The Boc Group | UK |
| 22 Tomkins | UK |
| 23 Vodafone Group | UK |

Source: elaboration of the writer.

4.2 The global distance between domestic accounting principles and US GAAP

By calculating the global comparability index, it has been possible to measure the distance between value obtained by the application of national accounting principles and US-based financial results, for companies already applying SFAS 141 and 142. This index has been calculated for net income, shareholders equity and ROE (return on equity), first taking as benchmark US Gaap and then taking national accounting principles (see Appendix B).

In all cases outliers values have been excluded from the analysis, as they may have brought to misleading results. It has been assumed that outliers occur when the index assumes values lower than -2 and higher than $+4$.

It is worth to point out that this kind of analysis has been carried out only for companies that produce a reconciliation between domestic and US Gaap. This sample is formed by only 13 companies, belonging to UK and Ireland (see Table 3.1).

Taking US Gaap as comparison term, net income results show that US Gaap are, on average, less conservative than UK Gaap. The index is 0,787, that means that net income expressed in accordance with US Gaap is 21,3% higher than value expressed in accordance with UK Gaap. These findings seem to be in contrast with previous studies, from which emerged that income obtained by the application of UK Gaap are higher than the ones obtained by applying US Gaap. This difference may be due to the non-amortisation of goodwill according to SFAS 142: this prescription reduces the amortisation charge, pushing up the net income (Weetman and Gray, 1990, 1991; Zambon, 1998). From the comparison between American accounting principles and Irish Gaap emerged that net income expressed in compliance with US Gaap is 15,4% lower, as the index results to be 1,154.

As for shareholders equity, the analysis shows that US-based values are higher than values expressed in accordance with UK Gaap. Index is equal to 0,747, that means a difference of 25,3%: this result confirm the findings of previous study, from which emerged that the global index moved from 0,765 to 0,795 (Weetman and Gray, 1993) to 0,81 (Zambon, 1998). The same conclusions have been reached comparing US and Irish Gaap: also in this case the index is lower than 1, meaning that shareholders equity calculated in accordance with US Gaap is 1,8% higher than shareholders equity obtained through the application of Irish Gaap.

The calculation of the global comparability index has been extended also to ROE, that it is given by the ratio net income and shareholders equity and for this reason may be used as a synthesis of the trend of the two figures. From the comparison between US and domestic Gaap, emerged that ROE obtained by the application of UK Gaap is 11,1% lower, while the value obtained through the application of Irish Gaap is 17,5% higher. Therefore, regarding to British companies the pattern outlined by net income and shareholders equity has been confirmed, while in the case of Irish companies, ROE reflects the behaviour of net income.

The second step has been given by the calculation of the global comparability index, taking as standardisation term local-Gaap values (e. g.: UK and Irish Gaap). This analysis showed the same results of the previous step. As for British companies, the net income global index is equal to 1,106, the shareholders equity index is 1,242 and the index referred to ROE is 1,086. These values are equivalent to a deviation of US-based results from national-based results of +10,6%, +24,2% and 8,6% respectively. As for Irish companies, global index assumed values equal to 0,890, 1,018 and 0,874 for net income, shareholders equity and ROE respectively. These values show that net income and ROE are higher when expressed in accordance to national accounting principles of 11% and 12.6%, while shareholders equity is 1,8% lower.

4.3 The partial distance between domestic accounting principles and US GAAP

As the global comparability index does not allow to value the contribution of each adjustment, the partial comparability index for net income and shareholders' equity has been calculated, in order to measure the impact of goodwill and amortisation of goodwill adjustments on financial results. Also in this case, US Gaap have been first taken as benchmark and then national accounting rules have been taken as term of comparison (see Appendix B).

Using US Gaap as benchmark for the analysis, results showed that, referring to net income, the value of goodwill expressed in accordance with UK accounting principles is 22,6% lower and amortisation of goodwill is 14,2% higher than values obtained through the application of US Gaap. Regarding to Irish companies, it emerged that goodwill according to local principles is 4,9% higher than value expressed in compliance with US Gaap. No adjustments referred to amortisation of goodwill have been recorded.

As for the impact on shareholders' equity, results showed that US-based values are 11,5% and 6,6% lower than UK-based values, respectively for goodwill and amortisation of goodwill. Regarding to Irish companies, considering that they did not record any adjustments for the amortisation of goodwill, the partial comparability index for goodwill is 0,893: it means that the value obtained by the application of Irish Gaap is 10,7% lower than value obtained through the application of US Gaap.

Using domestic Gaap as benchmark of the analysis, the partial comparability index calculation brought to opposite results in respect to the ones previously showed. As for net income, for UK companies index resulted to be equal to 0, 867 and 1,139 respectively for goodwill and amortisation of goodwill, indicating differences of -13,3% and +13,9% of US-based values in respect of UK-based values. Regarding to Irish companies, partial index for goodwill is 1,037, meaning that goodwill obtained by the application of Irish Gaap is 3,7% lower than value obtained in compliance with US Gaap. The calculation of the index for shareholders' equity showed that goodwill by the application of UK principles is 30,9% higher than the one obtained applying US Gaap, while amortisation is 8,6% lower. Regarding to Irish companies, goodwill in accordance with local accounting principles is 11% higher (index is 0,890) than goodwill obtained if US Gaap were applied.

5. CONCLUSIONS

This paper is concerned with the application of the new SFAS 141 Business Combination and 142 Goodwill and Other Intangible Assets, highlighting the way European companies listed on Nyse and Nasdaq faced their application in preparing accounting documents in compliance with US Gaap, as well as requested by the Securities and Exchange Commission.

The study is composed by three main steps:

- the sample has been chosen: European companies listed on US financial markets, closing their fiscal year in 2002 before December 31 has been taken into consideration;
- the empirical analysis has been carried out .A qualitative analysis has first been conducted, to assess whether the sample companies had already begun to account for their intangibles in accordance with new prescriptions. In the case of a positive answer, the quantitative impact on main financial results (net income and shareholders' equity) has been analysed, by calculating the comparability indexes, both global and partial, even if this step has been possible only for UK and Irish companies that produced a reconciliation in their annual report or in their Form 20-F; and
- on the basis of the empirical analysis, some conclusions have been pointed out.

Findings show that about half of the analysed companies already apply these Statements; yet the numerosness of the sample does not allow to trace a totally reliable pattern. Of these entities, most

of them prepare their consolidated financial statements in accordance with US Gaap. Thus it has not been possible to measure the quantitative impact on net income and shareholders' equity through the calculation of the comparability indexes.

It is worth to point out that companies applying in their reconciliation SFAS 141 and 142 and preparing their accounts in compliance with their domestic accounting principles (thus presenting a reconciliation between the two sets of accounting standards) are only UK and Irish companies. A reason for this behaviour may be linked to the fact that both UK and Irish accounting systems belong to Anglo-Saxon systems, as well as US accounting rules. Traditionally these countries have a very strong attachment with their domestic rules, even because it is widely diffused the belief that only few differences exist between accounting rules of countries belonging to the same accounting area. This study showed that it is not completely true (particularly for UK Gaap), strengthening this way results reached by previously researches. In respect of UK companies, dissimilarities became wider after the introduction of new SFAS: while Statement no. 142 prescribes the non-amortisation of goodwill, UK accounting principles continue to require companies to amortise its value.

Conclusions reached by this study are important when thinking about future developments in international accounting rules. Recently also International Accounting Standards Board (IASB) made some changes in its principles, in search of an alignment between IAS (now IFRS) and US Gaap. This assumes even more relevance because listed European companies will have to adopt IAS in preparing their consolidated accounts from 2005 onwards: the less difference there will be between the two sets of principles, the less costs companies will have to bear when deciding to list their stock on US financial markets.

A first limit of this work is given by the low numerosness of the companies considered, as, for the reasons previously mentioned, they constitute only a small portion of the European companies listed on Nyse and Nasdaq. Another consideration regards the reasonability to think that most of companies began to apply SFAS 141 and 142 for fiscal year 2002: therefore a possible development of this study might be the analysis of the Form 20-F (or Annual Report) referred to fiscal 2002.

APPENDIX A

a) Companies analysed in the study

| Company | Industry | Stock Exchange | First year listing |
|--|-----------------------------------|----------------|--------------------|
| France | | | |
| 1) Alstom | Diversified industrial | Nyse | 1998 |
| 2) Ilog | Software components | Nasdaq | 1997 |
| 3) Infovista | Software | Nasdaq | 2000 |
| Germany | | | |
| 4) IXOS Software | Software | Nasdaq | 1998 |
| 5) Lion Bioscience | Management solutions | Nasdaq | 2000 |
| 6) Siemens | Communication technology | Nyse | 2001 |
| United Kingdom | | | |
| 7) Allied Domeq | Distillers and brewers | Nyse | 2002 |
| 8) British Airways | Airlines | Nyse | 1987 |
| 9) British Biotech | Pharmaceuticals | Nasdaq | 1992 |
| 10) British Energy | Energy | Nyse | 1999 |
| 11) British Sky Broadcasting Group | Telecommunications | Nyse | 1994 |
| 12) BT Group | Telecommunications | Nyse | 1984 |
| 13) Cable & Wireless | Telecommunications | Nyse | 1989 |
| 14) Cambridge Antibody Technology Group | Pharmaceuticals | Nasdaq | 2001 |
| 15) Carlton Communications | Telecommunications | Nyse Nasdaq | 1993 1997 |
| 16) Danka Business System | Technology | Nasdaq | 1992 |
| 17) Diageo | Food | Nyse | 1997 |
| 18) Eidos | Technology | Nasdaq | 1996 |
| 19) Futuremedia | Technology | Nasdaq | 1993 |
| 20) Galen Holdings | Pharmaceuticals | Nasdaq | 2000 |
| 21) Imperial Tobacco Group | Tobacco | Nyse | 1998 |
| 22) Lastminute.com | Leisure, travel services | Nasdaq | 2000 |
| 23) Merant | Computer software and services | Nasdaq | 1992 |
| 24) MmO2 | Wireless communications | Nyse | 2001 |
| 25) National Grid Transco | Electricity | Nyse | 1999 |
| 26) Nds Group | Telecommunications | Nasdaq | 1999 |
| 27) Premier Farnell | Electricity | Nyse | 1996 |
| 28) Professional Staff | Staffing services | Nasdaq | 1996 |
| 29) Provalis | Pharmaceuticals | Nasdaq | 1993 |
| 30) QXL Ricardo | E-commerce | Nasdaq | 1999 |
| 31) Scottish Power | Energy | Nyse | 1997 |
| 32) Signet Group | Luxury goods | Nasdaq | 1988 |
| 33) Six Continents | Holding | Nyse | 1990 |
| 34) The Boc Group | Chemical | Nyse | 1996 |
| 35) Tomkins | Engineering and machinery | Nyse | 1995 |
| 36) United Utilities | Holding | Nyse | 1998 |
| 37) Vodafone Group | Mobiles | Nyse | 1988 |
| 38) Wolseley | Building materials | Nyse | 2001 |
| IRELAND | | | |
| 39) Hibernia Foods Limited | Food | Nasdaq | 1993 |

| | | | |
|---|--|--------|------|
| 40) ICON | Clinical research and development services | Nasdaq | 1998 |
| 41) Ryanair Holdings | Airline | Nasdaq | 1997 |
| 42) Skillsoft | School and educational services | Nasdaq | 1995 |
| 43) The Governor and Company of the Bank of Ireland | Banking | Nyse | 1996 |
| 44) Trintech Group | Computer hardware | Nasdaq | 1999 |
| LUXEMBURG | | | |
| 45) Stolt-Nielsen | Transportation, shipping | Nasdaq | 1995 |
| 46) Stolt-Offshore | Energy | Nasdaq | 1998 |
| THE NETHERLANDS | | | |
| 47) KLM Royal Dutch Airlines | Airlines | Nyse | 1957 |
| 48) Gucci Group | Multi-brand luxury goods | Nyse | 1995 |
| 49) Metron Technology | Support services | Nasdaq | 1999 |
| 50) Oc | Computer hardware | Nasdaq | 1984 |
| 51) Velcro Industries | Manufacturing | Nasdaq | 1970 |
| SWITZERLAND | | | |
| 52) Logitech | Computer hardware | Nasdaq | 1997 |

b) Companies excluded from the analysis

| Company | Reason for the exclusion |
|-------------------------|---------------------------------|
| Amdocs | US company |
| James Hardie Industries | Australian company |

APPENDIX B

a) Global comparability indexes

| US-based Global Comparability Indexes | | | |
|--|--------------------------------|---|-------------------------|
| Company | Net income global index | Shareholders equity global index | ROE global index |
| Ireland | | | |
| Ryanair Holdings | 0,967 | 0,983 | 0,983 |
| The Governor and Company of the Bank of Ireland | 1,342 | 0,981 | 1,367 |
| Mean | 1,154 | 0,982 | 1,175 |
| United Kingdom | | | |
| British Energy | 0,758 | 0,937 | 1,169 |
| Cable & Wireless | 1,086 | 1,003 | 1,089 |
| Diageo | 0,633 | 0,530 | 1,194 |
| Eidos | 1,021 | 1,000 | 1,021 |
| Imperial Tobacco Group | 0,910 | -0,083 | -10,926 |
| National Grid Transco | -1,025 | 0,850 | -1,557 |
| Premier Farnell | n. a. | n. a. | n. a. |
| Scottish Power | 0,887 | 0,809 | 0,624 |
| The Boc Group | 1,313 | 0,874 | 1,502 |
| Tomkins | 1,253 | 0,625 | 2,006 |
| Vodafone Group | 1,032 | 0,927 | 0,955 |
| Mean | 0,787 | 0,747 | 0,889 |
| National-based Global Comparability Indexes | | | |
| Company | Net income global index | Shareholders equity global index | ROE global index |
| Ireland | | | |
| Ryanair Holdings | 1,034 | 1,017 | 1,017 |
| The Governor and Company of the Bank of Ireland | 0,745 | 1,019 | 0,731 |
| Mean | 0,890 | 1,018 | 0,874 |
| United Kingdom | | | |
| British Energy | 1,195 | 1,059 | 0,855 |
| Cable & Wireless | 0,906 | 0,997 | 0,902 |
| Diageo | 1,579 | 1,886 | 0,838 |
| Eidos | 0,979 | 1,000 | 0,979 |
| Imperial Tobacco Group | 1,099 | 14,011 | 2,092 |
| National Grid Transco | 1,669 | 1,176 | 1,719 |
| Premier Farnell | n. a. | n. a. | n. a. |
| Scottish Power | 1,101 | 1,237 | 1,273 |
| The Boc Group | 0,762 | 1,144 | 0,666 |
| Tomkins | 0,798 | 1,601 | 0,499 |
| Vodafone Group | 0,967 | 1,079 | 1,043 |
| Mean | 1,106 | 1,242 | 1,086 |

b) Partial comparability indexes

| US-based Global Comparability Indexes | | | | |
|--|-----------------------------------|------------------------------|--|------------------------------|
| Companies | Net income partial indexes | | Shareholders equity partial indexes | |
| | Goodwill | Goodwill Amortisation | Goodwill | Goodwill Amortisation |
| Ireland | | | | |
| Ryanair Holdings | - | - | - | - |
| The Governor and Company of the Bank of Ireland | 1,049 | - | 0,893 | - |
| Mean | 1,049 | - | 0,893 | - |
| | | | | |
| United Kingdom | | | | |
| British Energy | - | - | - | - |
| Cable & Wireless | - | 1,043 | 0,968 | - |
| Diageo | 1,054 | - | 0,629 | - |
| Eidos | - | 1,004 | 0,633 | 1,126 |
| Imperial Tobacco Group | 0,839 | - | 2,015 | - |
| National Grid Transco | 0,519 | - | 0,972 | - |
| Premier Farnell | n. a. | n. a. | n. a. | n. a. |
| Scottish Power | 0,685 | 1,026 | 0,932 | 1,014 |
| The Boc Group | - | 1,016 | 0,961 | 0,998 |
| Tomkins | - | 1,179 | 0,295 | 1,127 |
| Vodafone Group | - | 1,582 | 0,562 | - |
| Mean | 0,774 | 1,142 | 0,885 | 1,066 |
| | | | | |
| National-based Global Comparability Indexes | | | | |
| Companies | Net income partial indexes | | Shareholders equity partial indexes | |
| | Goodwill | Goodwill Amortisation | Goodwill | Goodwill Amortisation |
| Ireland | | | | |
| Ryanair Holdings | - | - | - | - |
| The Governor and Company of the Bank of Ireland | 1,037 | - | 0,890 | - |
| Mean | - | - | 0,890 | - |
| | | | | |
| United Kingdom | | | | |
| British Energy | - | - | - | - |
| Cable & Wireless | - | 1,047 | 0,969 | - |
| Diageo | 1,085 | - | - | - |
| Eidos | - | 1,004 | 0,633 | 1,126 |
| Imperial Tobacco Group | 0,824 | - | 13,196 | - |
| National Grid Transco | 0,841 | - | 0,967 | - |
| Premier Farnell | n. a. | n. a. | n. a. | n. a. |
| Scottish Power | 0,717 | 1,024 | 0,916 | 1,018 |
| The Boc Group | - | 1,011 | 0,955 | 0,998 |
| Tomkins | - | 1,143 | -0,128 | 1,203 |
| Vodafone Group | - | 1,602 | 0,527 | - |
| Mean | 0,867 | 1,139 | 0,691 | 1,086 |

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