CONCEPTUAL DIFFCULTIES AND THE FEASIBILITY OF POLICIES FOR THE COMPANY'S GOODWILL

Feleaga Liliana

Academy of Economic Studies, Bucharest, Faculty of Accounting, liliana_malciu@yahoo.com

Feleaga Niculae

Academy of Economic Studies, Bucharest, Faculty of Accounting, nfeleaga@yahoo.com

Vasile Cristina

Academy of Economic Studies, Bucharest, Faculty of Accounting, cristina_sels@yahoo.com

Abstract: Goodwill represents a financial indicator which serves as an evaluation tool for the quality of the company's production structures. The evaluation and the recognition of the Goodwill raises may controversies, as for example: Is the Goodwill an asset or not? Is it kept within the assets part or is it subtracted out of the company owner's equity? Is it depreciated or it is sufficient to be included in the provisions? Therefore, the stakes for choosing one solution, or the other, should not be neglected. It is necessary to analyse the factors that influence the managerial decisions, when choosing a way to record the Goodwill. In this analysis we may use the theory of the Contract Costs. In its own path to eliminate the manipulation options for the published information, the international referential has supported within the past years, numerous revises and modifications regarding the Goodwill accounting treatment. Goodwill in the context of the international accounting convergence processes.

Keywords: Goodwill, accounting referentials, controversies, accounting convergence processes.

Theoretical Issues regarding the nature of the Goodwill:

Goodwill represents a financial indicator that serves as an evaluation instrument for the quality of a company's production structures. It is „the only asset that the competition cannot depreciate or destroy".[343] The specialty literature presents various methods for computing the Goodwill and the most important ones are as follows:[344]

A. Goodwill is determined as a difference between the real global value of an enterprise and the fair value of all its net quantifiable assets. This subtractive method, preferred by the accountants, is rather simple to be used, but has the major inconvenient that it does not explain the intangible components of owner's equity.

B. Goodwill is computed with the additive method, starting with the direct valorisation of its own components (registered marks, licenses, brands, distribution chains, s.o.). The additive method ignores though the interdependence of the asset component elements and its effects on the enterprise capacity, reasons for which it has been rarely utilised by the accountants.

C. Goodwill is determined on the basis of the estimations regarding the company's capacity to generate a result superior to the one which may lead to a non-risk participation of the invested capitals. From a practical perspective, this method imposes identifying the asset-generated cash flows, the upcoming cash flows for the shareholders (under the form of dividends), and the extra-added value brought by the company's sale.

C. Collette and J. Richard[3] analyse the subtractive method for determining the Goodwill, through the light of the dynamic and actuarial accounting procedures.[345] Within this vision, the Goodwill represents the difference at a certain point in time, between the actuarial value of the owner's equity and its dynamic accounting value. In other words, the Goodwill is the difference between the linear cumulated results (according to the actuarial accounting procedures) and the cumulated „dynamic" results. Beyond the difficulties for evaluating the Goodwill, it is asked whether this represents a feasible indicator for measuring the intangible capital of a company. Obviously, the answer is negative. One of the main

343 "To goodwill, the one and only asset that competition cannot undersell or destroy." Marshall Field, Goodwill, web page.

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characteristics of the intangible capital is its indirect relationship with the enterprise performance in terms of profit or market share, and its value is linked to the qualitative characteristics of the organisation, its competencies and flexibility. Such aspects cannot be measured and quantified using the Goodwill, an indicator built to estimate the market value according to some financial logistics on the short-term that sustain the shareholders' rights.

Accepting the fact that Goodwill actually measures the immaterial capital of a company, means giving credibility to the market when it estimates the value of that company. In real life, the market-estimated value is based (as Keynes said in 1936) more on a „conventional evaluation, the result of a collective psychology belonging to a large number of ignorant individuals", rather than on a long-term performance measurement. In other words, as an asset-evaluation issue, one cannot be right if he opposes to a multitude of individuals, no matter how ignorant or blind those persons are.

The recognition and the evaluation of the Goodwill – Controversies:

The arising problem is whether Goodwill represents an asset in the legitimate context of this word. Briefly, it can be easily stated that within the specialty literature it has been demonstrated that the experts' points of view are far from being convergent in all the aspects. A first argument against recognising the Goodwill is the fact that this „element" does not satisfy the definition of the „intangible" assets, as it has been presented in the IAS 38 standard, as follows: it cannot be separately sold form the acquired enterprise, therefore it doesn't have a separable character, and being identifiable only as a remaining part. Also, incurring an expense is not automatically translated into the process of creating an asset. W.P. Schuetze offers an example as to illustrate the above mentioned issue – an example about the business managed by his sister in a small Texan city. We quote: „She has recently bought a concurrent society, paying an extra 100,000$ over the purchased identifiable elements of the net assets. In return for the extra 100,000$, the seller accepted not to be concurrent with her business for the next 5 years. I explained to her that this represented acquired Goodwill and that, in conformity with the General Accepted Accounting Principles (US GAAP), it should be recorded as an asset. She started laughing and replied: try to pay with this asset all the wages, the rent and the electricity bills, or the dividends. The 100,000$ is actually just an expense."[346] It should not be neglected that, within the international vision, an asset represents a resource controlled by the enterprise that was generated by past commercial events and which is susceptible to bring future economic benefits to the company. Obviously, the Goodwill generates future economic benefits (positive cash flows), because it has the capacity to create, together with other assets, cash flows, and further the economic entity controls these economic advantages (as a result to a past transaction, the operation of enterprise grouping).

Another argument against recognising the Goodwill notion, is the fact that this „element" cannot be feasibly evaluated, excepting the moment when grouping the enterprises. In other words, Goodwill satisfies the criteria for being recognized as an asset, at the moment of purchasing a company, but not also after that point in time. Consequently, it has been stated that, in the case when the Goodwill is recognised as an asset, afterwards it must be subtracted from the owner's equity. Therefore, the practical procedures for treating the Goodwill, is equivalent to rejecting the Goodwill's status of an asset.

We consider though that there are similar difficulties to be encountered in the case of other tangible assets, for which there is no active market (for example the highly-specialised equipment market). And, despite all these, the mentioned type of equipment is recorded as an asset, according to the transaction amounts (acquisition cost). The question raising from here would be: why Goodwill is not treated in the same way? Also, ignoring the Goodwill, allows the future recognition of some non-realised revenues. For example, selling an enterprise for the sum of 100 mil. m.u., that has been previously acquired for the same amount, through a sale of titles – recorded in the accounting journals, at the value of only 60 mil. m.u., due to eliminating the Goodwill part), will generate a sale revenue of 40 mil. m.u., in the conditions in which the selling price and the purchase price are equal as value. Moreover, if the enterprise is to be sold at the value of 90 mil. m.u., a 30 mil. m.u. gain would be recorded, while in real facts this transaction is translated in a 10 mil. m.u. commercial loss.

[4] Schuetze, W.P., *What are assets and liabilities? Where is True North? (Accounting that my sister would understand)*, Abacus, volume 37, no. 1, 2001.

In the case in which the Goodwill is recognised as an asset, questions are raised on how it will be depreciated along the time. The accounting practice and theory generally sustain four divergent solutions for the Goodwill accounting treatment, as follows:

- maintaining the Goodwill as an asset, without any amortisation or provisioning;
- subtracting the Goodwill from the owner's equity;
- the capitalisation of the Goodwill and making provisions for it - in the case in which the acquired assets have depreciated;
- the capitalisation of the Goodwill and its amortisation.[5]

a) Maintaining the Goodwill as an asset, without any amortisation or provisions. There are experts who sustain the fact that the value of the Goodwill does not decrease in time, but on the contrary it maintains its value or even grows along its economic life. In other words, „the Goodwill represents an investment and must be kept in the Balance Sheet without any amortisation"[347]. C. Collette and J. Richard both consider that such a solution is not acceptable because the Goodwill represents a virtual asset that leads to the misrepresentation of the real and net status of the assets and of the result.

b) The imputation of the Goodwill from the owner's equity. The creators of this solution had as a starting point the fact that a company accepts to pay an extra-price for acquiring the assets belonging to another company, when it is estimated that, by purchase, they will obtain future economic benefits under the form of future superior incomes. Because these future extra-revenues will affect the owner's equity, then they may be compensated through the extra-payment made at the acquisition moment. This solution is though contested, because it creates a false image of a higher profitability of the company group, than the real state of facts.

c) The capitalisation of the Goodwill and creating provisions for it, in the case in which the purchased assets have been depreciated. Such a solution leads to a similar image with the one generated by the first one.

d) The capitalisation of the Goodwill and its amortisation for a period equal to the useful life of the bought or consolidated assets, at the moment of acquiring an enterprise. Some specialists plead for the necessity of depreciating the Goodwill, due to its own elements' economic nature. Therefore, the Goodwill may contain identifiable intangible assets that support depreciation, and which are not separately recorded, because their value cannot be feasibly determined. Also, some components of the Goodwill, as for example the „managerial team" or the „collective intelligence of the team" do not have a definite economic life. Consequently, not amortising the Goodwill does not allow the creation of a real image of a company's financial status and economic performances.

C. Collette and J. Richard sustain that the only rational solution is to amortise the Goodwill during its investment period. The amortisation of the Goodwill significantly influences the prepared an disclosed financial results of the company. Consequently, most of the enterprises take advantage of all these ambiguities belonging to the various types and incertitudes of theoretical issues, in order to develop an opportunistic attitude that serves their own perspectives and targets. That is why B. Martorz and F. Verdier criticize the following situation (considered by us representative for this issue): „When IBM acquired, in 1995, the Lotus Development Corporation, with the total sum of 3.2 billion $, the amount of 1.84 billion $ (that is 57% out of the acquisition price) has been allocated to the R&D expenses still in progress. IBM recorded this issue into its own Profit and Loss Account, by applying the rule which states that the R&D expenses represent expenses for the current financial year. Why this artificial method? Well, the answer is that the immediate recording of the R&D expenses within the Profit and Loss Account, allows the elimination of a big part of Goodwill, which further leads to the ability of diminishing the future amortisation and significantly increase the published financial result for the company. Also, this operation decreases the total value for both the owner's equity and the total assets, creating the illusion of a higher profitability".[348]

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[347] Venkatesan Sundararajan, *Accounting for Goodwill*, 1995, web page.
[348] Martory, B. şi Verdier F., *Comment traiter le goodwill? Pratique d'une théorie, théorie d'une pratique*, Comptabilité, contrôle, audit, tome 6, volume no. 2, september 2000.

Our opinion is not though the same with the one belonging to Professors C. Collette and J. Richard. Using a linear amortisation system, may lead to the creation of a false and deformed image of the enterprise, due to the fact that the Goodwill is a special asset with a relatively stable value on the short-term, and with potential spectaculars drops on the long-term. Most of the companies record the Goodwill in the Balance Sheet and treat it in the same way as for the Tangible Fixed Assets. Here, we must mention that while the value of the Tangible Fixed Assets rarely incur fast depreciation processes, on the contrast, the value of the Goodwill may disappear in only one second, if we reach the conclusion that the company paid too much on the Intangible Fixed Assets (for example, a registered mark is not „that original" as it has been considered at the beginning, or the demand for a new technology is very low). As an example, it is sufficient to offer the case of Financial Corporation of America (FCA), that paid in 1983, an extra 1.1 billion dollars in order to acquire also the company's Goodwill advantages. The duration for amortising the Goodwill has been settled at 30 years. In 1984, the FCA has recorded a 600 million $ loss, which in turn diminished its owner's equity with 75%. Between 1985 and 1986, the same company had profit, but again in 1987 it recorded a 470 million $ loss, generating a negative value for the owner's equity (minus 170 million $). At the end of 1988, American has been sold to another enterprise. At that moment in time, the FCA Balance Sheet presented a non-amortised Goodwill of 950 million $, not covered by the sale transaction. The need for transparency and avoiding the utilisation of an arbitrary accounting system, both represented reasons which laid the foundations for giving up to the Goodwill amortisation procedure presented in some performant accounting referentials.

The stakes for choosing one solution, or the other, previously analysed, should not be over passed. This is the reason for which it is absolutely necessary to analyse the influencing factors for the managerial decisions when choosing the accounting method as to record the Goodwill. In this analysis, we shall utilize the theory of *Contractual Costs.* Watts and Zimmerman have studied numerous case studies on the contractual costs. Some of these studies worth our attention, especially the *Agency Costs* matters.[349]

The analysis for the agency costs, worth identifying the agency relationships susceptible of influencing the accounting policies to be chosen. It is about settling relationships between: a) the managers and the shareholders; b) the shareholders/managers and the creditors; and c) the company and its external environment. Through the procedure of including within the contracts some compensatory plans, or some additional liability restrictions, the managers actually accept to link their interests to the ones belonging to the shareholders and to the ones of the creditors. Positive researches have emphasized that managers tend to have an opportunistic behaviour, that is to choose those accounting policies and procedures which maximise their remunerations, reduce or avoid the contractual restrictions and minimise possibilities of political interference. Using such results, within the Goodwill accounting analysis, intuitively leads us to the following conclusions:[350]

- in the case of the companies that already have such managerial compensation plans, it is preferred to apply an accounting method with no adverse effects upon the accounting financial result: i) maintaining the Goodwill in the assets part, with no amortisation or provisions, <u>or</u> ii) subtracting Goodwill out of the owner's equity side of the patrimony.
- in the case of those enterprises having no restrictions concerning the additional liability, or balance rate restrictions, it is preferred to apply a method which doesn't diminish owner's equity: i) the capitalisation and the amortisation of the Goodwill; <u>or</u> ii) the capitalisation and provision-making for the Goodwill.

Goodwill and the International Standards:

At international level, the treatment for the Goodwill is the object of the IFRS 3 accounting standard – *Groups of Enterprises.* This standard provides rules for recognising the Goodwill (positive or negative), generated from the acquisition of other enterprises. In the case of company-acquisition operations, any over passing of the acquisition costs, beyond the limit of the assets' fair value and of the acquired quantifiable liabilities, must be described as part of the Goodwill, as an asset.

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[349] R.L. Watts, J.L. Zimmerman, *Positive accounting theory*, Prentice Hall International Inc, 1986.

[350] Also relevant is the 1998 analysis of P. Gore, F.M. Taib and P.A. Taylor, *"Accounting for Goodwill: what factors influence management preferences?"* – the web page. This paper represents an investigation of the British stock exchange companies, between 1993-1995, and tries to identify which one of the six mentioned accounting treatments foreseen within the project "Goodwill and other intangibles", is the best for managing the Goodwill.

The Goodwill generated through an acquisition process represents a payment made by the buyer, as a consequence to anticipating future economic benefits. These future economic benefits may result form the merger between the identifiable assets acquired, or from individually analysed assets that do not meet all conditions for being in the financial statements, but for which the buyer is willing to perform a payment within the acquisition transaction. There are situations in which the apparent existence of the Goodwill indicates the fact that the fair value of a significant identifiable asset, hasn't been correctly determined. For example, we may choose a company that has as object of activity the minerals extraction and their sale on a market with continuous price changes/quotations. In order to determine the value of the non-extracted minerals, there are evaluation methods based on the current market prices. Due to the aspect that the minerals reserves represent the only important/significant asset of that company, which in turn has its activity limited to the minerals extraction, then the value of those reserves essentially determines the value of the company. In the case in which a potential buyer would accept to pay for this enterprise a higher price than the conventional value of the reserves, then it means he estimates a greater value for the reserves than the conventionally-settled value. The payment excess, over the real value conventionally determined, must be added to the value of the reserves.[351]

At the purchase date, the acquired Goodwill, within a group of enterprises, is evaluated at its acquisition cost and also recognised as an asset. After its initial recognition, that Goodwill must be evaluated as a difference between its acquisition cost and the cumulated losses generated by the depreciation. In other words, the Goodwill is non-amortisable, but it bears a depreciation test which may lead to the recognition of some value losses.[352] If the share owned and controlled by the buyer, out of the total net asset at its fair value, overpasses the titles' acquisition cost, then the buying company must re-identify and revalue the assets, liabilities and potential liabilities of the acquired enterprise, as well as the revaluation process for the acquisition cost. The negative difference of acquisition may have one of the following causes:

- errors in the revaluation of the assets' fair value, of the liabilities and potential debts of the acquired company (for example, the future potential costs haven't been correctly emphasized within the fair value of the assets, liabilities and potential liabilities);
- revaluation errors for the titles' acquisition costs;
- the obligation provided by some accounting standard, as to revaluate an asset at another value than the fair one;
- an acquisition at a good price.

If, as a result of the revaluation, a negative purchase difference is still kept, then the Profit and Loss Account will be definitely affected. On the 10th of January 2008, IASB – International Accounting Standards Board has published a revised and modified form of the IFRS 3 standard, which becomes compulsory starting the 1st of July 2009. The revised accounting standard, allows an economic entity to choose on how it evaluates the minority interests (non-controlling interests), as follows: either using the *entire Goodwill method* – at the fair value; or by using the proportional *corresponding part out of the total net asset* of the purchased company. Under these circumstances, the Goodwill becomes measurable as a difference between the following items:

- the sum of: i) the transferred titles' fair value, at the acquisition date, ii) the value of minority interests, and iii) in the case of a company grouping operation, the fair value of the buyer's previously-held shares within the bought company's total social capital;

AND

- the net value at the acquisition date, for the purchased identifiable assets and liabilities, valued in conformity to IFRS 3.

Goodwill is measured at the date when the buyer gains full control over the acquired company.

This situation held a slight change comparatively to the current in-use-method, according to which the buyer separately evaluates the Goodwill for each transaction, by comparing the acquisition cost with the percentage of fair value belonging to the net identifiable assets, at the date of each acquisition.

[351] Pricewaterhouse Coopers, *Understanding IAS*, 2001, web page.

[352] In order to perform the Depreciation Test for the Goodwill, one should use the policies and procedures presented within IAS 36 – *Depreciation of Assets*.

To sum up.....

Summing up the analysis upon the accounting principles and practices regarding the treatment of the Goodwill, leads us to the following main conclusion: when the different types of regulations are ambiguous, with difficulties in settling frontiers, then the accounting rules become insufficiently developed and therefore the companies have an opportunistic type of behaviour.

Inevitably, under such circumstances, there is a continuous race between the authorities (wanting to develop and implement very detailed rules) on one side, and the enterprises that wish to explore those rules as to maximise their own utilities, on the other side. The Goodwill represents a residual value with extremely ambiguous characteristics. All theoretical considerations, avoid to compare between the computing the depreciation or the amortisation, while the stock exchange companies try to minimise the financial impact of their value losses. For this reason, some of the accounting referentials (including the Romanian one), provide the Goodwill amortisation solution, as a substitute when there's no better alternative.

The solution given by the international accounting referential seems to reconciliate the theoretical vision, with the accounting practice for the Goodwill issue, regulating both the transparency matter for the grouping operations towards their shareholders and creditors, and the future expense effects linked to this asset, over the company's financial result. The above described solution creates major inconvenients with some of the national accounting standards, in the matters of the initial recording of a group of enterprises, and also in the depreciation/amortisation issue for the Goodwill. It is very likely though, that most of these incompatibilities will disappear once the international accounting convergence processes are further developed.

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