ASPECTS CONCERNING THE EVALUATION AND ACCOUNTING OF GOODWILL

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In relation to the concept of "goodwill", there have been many debates for decades, and it continues to be, nowadays, a topic of real interest for various categories of information users, especially in the conditions of the current economy where the resilience and performance of the companies in the market is influenced by intangible assets to a greater extent than the tangible material assets. The controversies that have arisen in relation to the goodwill are related to the method of estimation, entry into the accounting records, and especially by the method of its depreciation/amortization. This article focuses on the analysis of the national and international rules that regulate the recognition and presentation of goodwill in the financial statements and the presentation of some current points of view of the IASB/FASB in relation to projects re-examining goodwill accounting, and specifically, the measurement of goodwill post-acquisition.

***Key words**:* Goodwill; intangible assets; mergers and divisions; business combinations; IFRS.

JEL Classification Codes: M41.

1. INTRODUCTION

The main motivation for conducting this research is given by the fact that, in the current economy, companies manage to cope with competition, to grow in the market and increase their performance due to products/services that are appropriate for ream needs in the market, but, at the same time, supported by a set of intangible elements that cannot be found entered in the individual financial statements, being generated internally. The ensemble of these intangible elements that contributes to the support and development of the business, such as, for example, the clients, the foot traffic, the reputation, trained labour, organizational culture, etc. and that are not entered in the individual accounting records of the entity are usually valuated when the overall valuation of the company is carried out, the valuation purpose usually being the company sale or its participation into a reorganization operation such as a merger/division. Our present research is justified especially by the major international and national interest in the valuation and accounting treatment of goodwill (due to its high value and the way in which different information users make decisions that are implicitly related to this intangible element likely to influence to a great extent the value of the company). For example, a material published by International Valuation Standards Council (IVSC), to which I will refer several times hereinbelow, quotes a study carried out by the CFA Institute, the global association of investment professionals, which highlights the importance of this ensemble of intangible elements worldwide: "CFA Institute gathered 2019 goodwill balances for some of the world's largest economies. In the United States, corporations in the S&P 500 had USD3.5 trillion of goodwill in 2019, which represents 42.2 percent of the equity and 9.3 percent of the assets of such companies. Goodwill for all U.S. public companies was USD5.6 trillion in 2018 and represented 40.5 percent of equity and 7.7 percent of the assets of those public companies with goodwill. Goodwill balances of the largest corporations in the United Kingdom, Europe and Canada – jurisdictions following IFRS – ranged from 21-41 percent of equity in 2019"

In this paper, I will approach the accounting analysis of goodwill both from the national and the international perspective, and I will also highlight the differences seen between the accounting treatment required by different reference accounting systems.

In my opinion, the paper is included both in the category of fundamental research and in that of the research of the existing practice in the field. The article is based on qualitative and quantitative research methods (research of the practice in the field, case study research, methods of examining and measuring phenomena), and as data sources I will mention: observation of phenomena, documents and texts, impressions and reactions of the researcher (the author).

2. THE SIGNIFICANCE OF THE GOODWILL

Goodwill, considered the most common non-identifiable intangible asset, results from a transaction. It is considered the amount by which the cost of an acquired business exceeds the sum of its identifiable net assets. The author Jeffrey A. Cohen raises the following question in his specialty paper "Intangible assets. Valuation and economic benefits' why would there be a 'surplus', why would someone pay more than fair value for something. The author believes that there could be three reasons to pay more than "fair value":

- ***Misidentification***
- ***Wrong valuation***
- ***Uncertainty***

I believe that the first two reasons are caused by errors in identification and valuation, which are isolated, random situations and what the author considers to be the third reason is actually what the goodwill actually represents. It is therefore believed that a customer would pay more than the fair value the net assets of a company if the potential customer knows that the company has developed up to that point unidentifiable intangible assets that have the ability to generate future economic benefits. I would not call this third reason "uncertainty", but rather the "confidence" granted to some elements "unseen and not entered in the accounting records of the company" to contribute to the resilience and increase of the company value in the market. Why are these elements not entered in the accounting records? Because as we will see in the content of the article, many of these are generated internally and do not meet the criteria for recognition and entrance in the accounting records.

According to R. Gynther (citat în Sarra K, Baghar N, El Kabbouri M., 2018), goodwill can be analyzed from two ways:

- ***Future excess profit concept***: According to this view, goodwill is the present value of the excess of expected future profits over that considered to be a normal return on the total tangible assets. Goodwill is the net present value of those assets difficult to list and value separately.
- ***Residuum concept***: Intangibles are the residuum, the balance of the legitimate values attaching to an enterprise as a totality, over the sum of the legitimate values of the various tangible properties taken individually.

3. ASSESSMENT AND RECOGNITION OF THE GOODWILL IN THE FINANCIAL STATEMENTS

In order to understand this section of the paper, I believe that it is useful to first briefly present the accounting regulations that are applied by companies in Romania. Currently, in Romania, one of the following reference accounting systems is applicable to companies:

- unlisted companies (which do not have securities traded on a stock exchange) apply the regulations stipulated in OMFP 1802/2014 on the individual annual financial statements and the consolidated annual financial statements;

- companies whose securities are admitted to trading on a regulated market) apply the regulations of the International Financial Reporting Standards (IFRS) approved by OMFP *(Order of the Minister of Public Finance)* 2844/2016.

Following the analysis of the two reference accounting systems, we can highlight the following aspects related to the assessment and recognition of goodwill.

The accounting treatment of goodwill according to OMFP 1802/2014 on the individual annual financial statements and the consolidated annual financial statements

From the content of the accounting regulations applicable to unlisted companies, we extract the following aspects related to the **goodwill**:

- **It is recognized, as a rule, when the consolidation is carried out**, and represents the difference between the cost of purchase and the fair value at the date of the transaction, of the part of the net assets acquired by an entity.

In the individual annual financial statements, the goodwill can only be recognized in the case of the transfer of all assets or a part of them and, as the case may be, of liabilities and equity, regardless of whether it is made as a result of the purchase or as a result of merger operations. In order to enter the goodwill in the accounting records separately, the transfer must be related to a business, represented by an integrated set of activities and assets organized and managed for the purpose of obtaining profits, recording lower costs or other benefits.

- Expenditure on brands, publication titles, customer lists and other similar items in the **fund generated internally** cannot be differentiated from the cost of developing the entity as a whole. Consequently, such elements *are not recognized as intangible assets.*
- If the goodwill is treated as an asset, **it is usually depreciated within a maximum period of 5 years**. However, in exceptional cases where the useful life of the goodwill cannot be assessed in a reliable manner, entities may amortize the goodwill systematically over a period of more than 5 years, provided that this period does not exceed 10 years. When adjustments have been made for the goodwill for depreciation, the related depreciation expense must be subsequently adjusted to allocate the resulting book value on a systematic basis over the remaining amortization period established for that asset. The adjustments for the depreciation of the goodwill correct its value (accounting item 6817 “Operating expenses regarding the adjustments for the depreciation of the goodwill" = 2071 "Positive goodwill"), without being subsequently resumed in the income.

The accounting treatment of goodwill according to the accounting regulations of the International Financial Reporting Standards (IFRS) approved by OMFP 2844/2016

In the IFRS content we find standards that present the recognition of goodwill in the financial statements, its accounting treatment and the assessment of its depreciation. Among them, mention should be made of: IFRS 3 Business Combinations, IAS 38 Intangible assets and IAS 36 Impairment of assets.

From the content of these standards, I will extract some aspects, in order to understand how this item is recognized in the financial statements and how the goodwill is treated according to IFRS.

- **IFRS 3 Business Combinations** *defines a business combination* as a transaction or other event whereby an acquiring entity obtains control over one or more businesses. An entity must account for each business combination using the *acquisition method*. *The last step of this method* (after identifying the acquirer, determining the acquisition date, recognizing and measuring the identifiable assets acquired, liabilities that are undertaken, and any non-controlling interests in the acquired entity) **implies the recognition and measurement of the goodwill** or a gain from a purchase in advantageous conditions

The acquiring entity must recognize the goodwill on the date of acquisition, based on the following formula:

Goodwill = Transferred consideration

+

The value of any non-controlling interests in the acquired entity

+

Fair value as of the acquisition date of the equity interest previously held by the acquiring entity in the acquired entity (in a staged business combination)

\- The net values from the acquisition date of the identifiable assets acquired and liabilities undertaken assessed according to the current IFRS

- **IAS 38 Intangible assets** specifies that *the goodwill that is recognized in a business combination* is an asset that represents the future economic benefits resulting from other assets acquired in a business combination that are not individually identified and recognized separately. Future economic benefits may result from the synergy between the identifiable assets acquired or from assets that do not meet the conditions for recognition, individually, in the financial statements. **The internally generated goodwill should not be recognized as an asset** (due to the fact that it is not an identifiable resource, in other words, it is not separable and it does not result from contractual rights or other legal rights, controlled by the entity that can be reliably valued at cost either.

- **In IAS 36 Impairment of assets**, it is mentioned that at the end of each reporting period, the entity must assess whether there are indications of asset impairment. If such indications are identified, the entity must assess the recoverable amount of the asset. Even if there is no indication of an impairment, the entity **must annually test the goodwill** acquired in a business combination for impairment

Goodwill **does not generate cash flows independently of other assets** or groups of assets and often contributes to the cash flows of several cash-generating units. **In order to perform impairment tests**, *the goodwill acquired in a business combination must be* **allocated, from the acquisition date**, *to each unit or group of cash-generating units* of the acquiring entity deemed as *benefiting from the synergies of the business combination*, regardless of whether other assets or liabilities of the acquired entity are allocated to those units or groups of units. **An impairment loss recognized for goodwill** *should not be carried over in a later period.* IAS 38 Intangible assets prohibits the recognition of internally generated goodwill. **Any increase in the recoverable amount of goodwill** *in periods subsequent to the recognition of an impairment loss* is most likely an increase in **the internally generated** goodwill, rather than a carrying over of the impairment loss recognized for the acquired goodwill.

Example of entrance of the goodwill into the accounting records and its depreciation according to OMFP 1802/2014 on the individual annual financial statements and the consolidated annual financial statements

At the beginning of year N, company A acquires 80% of company B, paying the amount of 750,000 RON. The balance sheet of company B at the date of acquisition is as follows:

Balance sheet of B

Items	Amounts (RON)
IT program	5,000
Licenses	1,000
Land	150,000
Buildings	420,000
Technological equipment	250,000
Raw material	20,000
Finished products	60,000
Receivables	12,000
Liquid assets	58,000
Total assets	**976,000**
Long-term bank loans	120,000
Commercial liabilities	10,000
Wages	30,000
Amounts payable to the state budget	25,000
Total liabilities	**185,000**
Equity	400,000
Reserves	20,000
Retained earnings	150,000
Profit or loss	221,000
Total equity	**791,000**

At the acquisition date, the fair values corresponded to the historical values for most of the elements, except for the following: land 200,000 RON, technological equipment 260,000 RON, and raw materials 18,000 RON. We consider that at the end of year N the inventory value of the goodwill established by the inventory commission was 50,000 RON.

We will focus on: the assessment of the size of the goodwill, the accounting of the goodwill and the annual amortization of the goodwill for the maximum period specified by OMFP no. 1.802/2014, as amended and supplemented, as well as the accounting of goodwill depreciation.

Solution:

Calculation of the goodwill:

– calculation of the net accounting asset (ANC) of company B, valued at fair value: ANC = Assets identifiable at fair value – Liabilities identifiable at fair value

ANC = (5,000 RON +1,000 RON +200,000 RON +420,000 RON +260,000 RON +18,000 RON +60,000 RON +12,000 RON +58,000 RON) – (120,000 RON +10,000 RON +30,000 RON +25,000 RON) = 1,034,000 RON- 185,000 RON= 849,000 RON

– calculation of the net accounting asset acquired by company net A: 849,000 RON x 80% = 679,200 RON

– assessment of the goodwill (FC):

FC = Price paid – ANC acquired by company A = 750,000 RON – 679,200 RON = 70,800 RON

Recognition of the goodwill:

– purchase of shares, for the price of 750,000 RON:

750,000 RON	**261** Shares held in affiliated entities	=	**512** Current bank accounts	750,000 RON

– recognition of positive goodwill

70.800 RON	**2071** Positive goodwill	=	**261** Shares held in affiliated entities	70,800 RON

Now the balance of account 261 is 679,200 RON (750,000 RON –70,800 RON), i.e. the net accounting asset acquired by A.

Amortization of goodwill over a maximum period of 5 years (70,800 RON / 5 years = 14,160 RON/year):

14,160 RON	**6811** Operating expenses related to depreciation of property	=	**2807** Amortization of goodwill	14.160 RON

d) Goodwill depreciation:

Book value at the end of year N = 70,800 RON– 14,160 RON = 56,640 RON

Stock value= 50,000 RON

Depreciation loss = 56,640 RON – 50,000 RON = 6,640 RON

6,640 RON	**6817** Operating expenses related to adjustments for goodwill depreciation	=	**2071** Positive goodwill	6,640 RON

4. CONCLUSIONS

By analysing the two reference accounting systems, we notice differences in terms of the way of reflecting the depreciation of the goodwill, because according to IFRS, the amortization of the goodwill is not allowed, it only allows for carrying out of depreciation tests, and in if a depreciation is found, its value is reduced. The problem of introducing the possibility to amortize goodwill was on the agenda of IASB and FASB. Thus, as it can be found in a few articles published by IVSC "in the fall of 2019, the IASB and FASB began projects re-examining goodwill accounting, and specifically, the measurement of goodwill post-acquisition. Central to the considerations of such projects was the potential reintroduction of goodwill amortization after a 20-year hiatus. The CFA Institute recently released the results from its investor survey. With 1,607 respondents collected from a random sample of CFA Charterholders, the feedback is clear: Investors don't want a reversion to amortization, they do want improved disclosures, and they demand a unified global approach." During the research carried out by IVSC with the purpoose of answering the question "*Is Goodwill a Wasting Asset*?" goodwill components were analysed (Reputation, Future intangible value, Workforce, Synergies, Assemblage Value) and the conclusion was that "The evidence set out here indicates that goodwill is not a wasting asset. This conclusion is supported by both a functional analysis of the components of goodwill and consideration of how businesses are valued and priced for transactions."

The more complex problems arise in carrying out the goodwill impairment test. According to IFRS, goodwill is tested in the year of acquisition, then annually at any time during the year, but on the same date each year. Valuation experts are involved in carrying out the impairment test because the assessment of the recoverable value requires a specific methodology (the fair value is estimated minus the costs of selling the cash-generating unit (CGU), respectively the internal value (in use) of the CGU. In order to assess these values, special valuation techniques are used, for example discounting techniques - Discounted cash flows, based on financial projections, which presents the same difficulties in making credible financial projections and estimating a reasonable discount rate as in the case of enterprise valuation. In order to assess the book value of the cash-generating unit, the experts involved in carrying out the UGN impairment test apply the following procedure:

Net working capital
+ Directly attributable tangible and intangible assets
+ allocated goodwill
+ Allocated part of the company assets
- <u>Attributable liabilities, as the case may be</u>
= **Book value of the cash generating unit (UGN)**

After assessing the book value of the UGN as well as the recoverable value of the UGN (fair value minus the cost of sale, respectively the usage value) comparisons are made between the resulting values and it is determined whether or not there is an impairment of the UGN and implicitly of the goodwill.

The problem of assessing the goodwill and carrying out its annual depreciation test requires a close collaboration between the company managers, accounting experts and valuators, the result of their good collaboration leading to the improvement of the qualitative characteristics of the information provided through financial and non-financial reporting.

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