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Normal regulation of the recognition and evaluation of the goodwill

Abstract

The international accounting and financial reporting standards for the reflection of goodwill in the reporting companies are analyzed. The peculiarities of recognition of internally generated goodwill and goodwill as a result of the merger of enterprises are presented. The ratio of goodwill and other intangible assets to the total assets in different countries of the world is analyzed. Since goodwill is not amortized, and its write-off should be carried out by testing for the subject of its depreciation, in the conducted study, an assessment is made of this method of writing off goodwill from the balance sheet.

Keywords

intangible assets, goodwill, internally generated goodwill, statutory regulation, International Financial Reporting Standards

Introduction

Changes in the global economic process, focusing on increasing the value of information and intellectual resources also update the need to find new ways to create material wealth. A characteristic feature of the modern economy is the growth of the role of intangible assets, in particular goodwill, in the formation of the value of companies. At present, in the world of practice, there is no single method of recognition, accounting and order of reflection in goodwill reporting. The study of this issue is devoted to the work of such accounting practitioners and scholars as A. Beatty, J. Weber[1], B. Lev[2], M. Hirschey, V.J. Richardson[3], K. Ramanna, R. Watts[4], K.G. Chalmers[5], I. Yaremko[6] and others.

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[1] A. Beatty, J. Weber, *Accounting discretion in fair value estimates: an examination of SFAS 142 Goodwill impairments*, „Journal of Accounting Research” 2006, N 44, p. 257-288.

[2] F. Gu, B. Lev, *Overpriced shares, Ill-advised acquisitions, and goodwill impairment*, „Accounting Review” 2011, Vol. 86, N 6, p. 1995-2022.

[3] M. Hirschey, V.J. Richardson, *Investor underreaction to goodwill writeoffs*, „Financial Analysts Journal” 2003, Vol. 59, N 6, p. 75-84.

[4] K. Ramanna, R. Watts, *Evidence on the use of unverifiable estimates in required goodwill impairment,* „Review of Accounting Studies”, Vol. 17, N 4, p. 749-780.

[5] K.G. Chalmers, J.M. Godfrey, J.C. Webster, *Does a goodwill impairment regime better reflect the underlying economic attributes of goodwill?*, „Accounting and Finance” 2011, Vol. 51, N 3, p. 634-660.

[6] I.Y. Yaremko, *Economic categories in the accounting methodology: monograph.*, Kamenyar, Lviv 2002.

The purpose of the study is to analyze the international legal practice regarding the recognition and measurement of goodwill in the financial statements of companies.

Presenting the material

The basis for recognizing goodwill in the financial statements is the acquisition of a company that owns an internally generated value that exceeds the fair value of its identifiable assets. International Standard of Financial Reporting (IFRS) 3 „Business Combinations" defines goodwill as an asset that represents future economic benefits arising from the use of other assets acquired in a business combination that are not identified and recognized separately. Goodwill's initial value is measured at cost, which is defined as the difference between the amount paid to the buyer and the sum of all balance assets and liabilities at the date of acquisition of the company[7].

International Financial Reporting Standards consider goodwill as two distinct categories: internally generated goodwill (IAS 38) and goodwill arising from the combination of enterprises (IFRS 3). Internally generated goodwill has the following features:

– is not subject to recognition as an asset because it is not recognized as a resource, which is identified and can be reliably estimated, and accordingly cannot be separated from the organization and does not arise from contractual or legal rights;
– as a result – there are no calculation methods and method of its estimation;
– does not belong to the organization on the right of ownership, cannot be alienated, it cannot be sold, presented or given.

A characteristic feature of goodwill, which distinguishes it from other assets, is the inalienability of goodwill from the company. The goodwill value is an estimate of the aggregate of company resources that give the consumer motivation to purchase a product created by the company and brings about this additional income[8]. At the same time, in the accounting environment, the opinion is that the acquired goodwill generates profits only for a limited period of time, after which this asset ceases to bring economic benefits and should be written off. It is important to note that the buyer can receive profits and after the write-off of the acquired goodwill, but these excesses often bring in-generation goodwill to the buyer.

[7] *IFRS 3 „Business Combinations"*, https://www.iasplus.com/en-us/standards/international/ifrs-en-us/ifrs3?set_language=en-us [access: 27.06.2018].

[8] A.E. Ivanov, *Goodwill: a brief history of the evolution of the approaches to understanding the economics, evaluation and recognition in financial accounting*, Rusains, Moscow 2016.

An estimated value of the world's largest venture companies by experts The Wall Street Journal shows that the ratio of the market value of most of the listed companies to their equity varies within 3-17[9].

The Report *Worldwide application of IFRS 3, IAS 38 and IAS 36, related disclosures and determinants of non-compliance*, prepared by the Association of Chartered Certified Accountants (ACCA), examines the application of the three standards of IFRS 3, IAS 38 and IAS 36 in the accounting practices of European countries and some other countries that have adopted international reporting standards or declare a significant convergence of national standards and IAS[10]. Approximately 17% of the sample consists of British companies (91), 8% of French (45) and 7% of Australian companies (38). The share of other countries is much smaller. All companies were different branches of the economy, but none of them belonged to the financial sector (reports of banks, insurance companies, investment funds and so on were not considered). Of the total number of enterprises (544) involved in the survey, 517 companies have at least one type of intangible assets in the statement of financial position (not including goodwill). Significant amounts of intangible assets (excluding goodwill) are recognized as a result of mergers (mergers, acquisitions). In general, a significant proportion of non-current assets of companies consists of intangible assets.

Fig. 1 shows the ratio of goodwill and other intangible assets to the total assets of different countries around the world (according to the ACCA Report).

As can be seen from fig. 1, the value of goodwill exceeds the amount of intangible assets for virtually all countries, with the exception of Portugal, Italy, Greece and Malaysia. Thus, intangible assets relate to the most significant types of assets in a large number of companies in the major stock markets of the world. Also, the statistics of this report show that in Great Britain, Belgium, Hong Kong, Australia, Ireland, France, Denmark and the Netherlands, up to 39% of the total assets of companies occupy intangible assets (including goodwill). Companies in Malaysia, Greece and China invest the least in intangible assets (less than 11% of total assets, including goodwill).

No company in the study applies a revaluation model for intangible assets, all companies use the cost method for the valuation of intangible assets (cost model). This fact improves the comparability of IFRS financial statements with reporting from companies from China and the United States, where the revaluation model for intangible assets is not allowed.

[9] *The billion dollar startup club,* https://www.wsj.com/graphics/billion-dollar-club/ [access: 28.06.2018].

[10] *Worldwide application of IFRS 3, IAS 38 and IAS 36, related disclosures, and determinant sof non-compliance,* https://www.stir.ac.uk/research/hub/publication/14929 [access 27.06.2018].

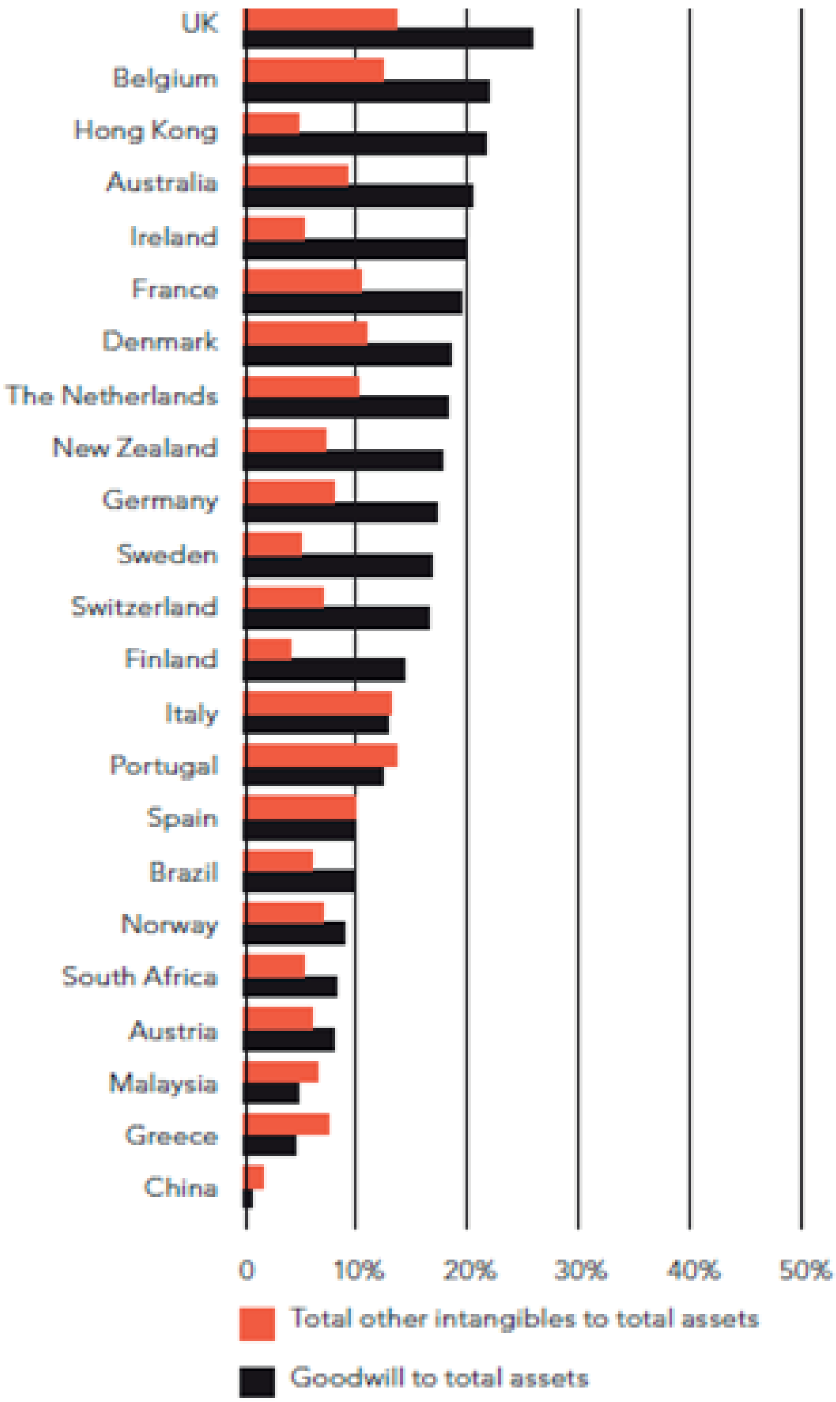

Figure 1. Intangible assets (other than goodwill) and goodwill as a percentage of total assets, per country

* Source: *Statement of financial accounting standards No. 141 „Business combinations"*, https://www.fasb.org/pdf/fas141r.pdf [access: 27.06.2018].

In accordance with IFRS 3, goodwill is not subject to depreciation. Instead, the purchasing organization must test it annually for the purpose of depreciation. For the first time, goodwill was presented in the balance sheet at cost of acquisition less impairment losses, offered by Frenchman J. Charpentier[11], however, in the accounting standards of goodwill testing for impairment was introduced only in 2001 with the adoption of US-GAAPs No. 141 „Business Combinations"[12] and # 142 „Goodwill and Other Intangible Assets"[13]. Instead of depreciation, in these standards, it is proposed to annually test goodwill for impairment. In 2004 IFRS 3 „Business Combinations" was adopted, which also considers goodwill as an unamortized asset subject to annual testing for impairment. These American and international standards are an example for many national standards. Goodwill testing for impairment testing is one of the most challenging in modern accounting and it is devoted to IAS 36, „Impairment of Assets"[14].

In essence, this means that goodwill should be measured and its depreciation assessed. Testing for impairment can be done more often if events that occur indicate the possibility of its depreciation. The most difficult to test goodwill for impairment is to determine the value of use. The value from use is the present value of future cash flows. Goodwill does not generate cash flows separately from other assets or groups of assets, but in many cases contributes to generating cash flows by generating units. Therefore, goodwill is tested for impairment at the unit-level unit that generates cash, which is the smallest group of assets that provides cash inflows. Goodwill acquired in a business combination, should be distributed among all the units that generate cash.

Testing for impairment of goodwill, which is held in several stages: identification units, which is divided between goodwill; distribution of goodwill between these units; verification of generating units for impairment; recognition of impairment loss (if any).

The test for the depreciation of units containing goodwill is carried out by comparing the book value of the unit, including goodwill, with the amount it reimburses. The sum of the reimbursement amount is greater than the value of use and the net selling price. The calculation of the value of use includes: estimating the future inflow and outflow of cash in connection with the subsequent use of the cash generating unit; the application of the appropriate discount rate.

If there is an impairment loss unit containing goodwill and generating cash flow, then the amount of damage, the amount of goodwill recognized. If the amount of the loss

[11] J. Charpentier, *Étude juridique sur le bilan dans les sociétés par actions,* A. Rousseau, Paris 1906.

[12] *Statement of financial accounting standards № 141 „Business combinations"*, https://www.fasb.org/pdf/fas141r.pdf [access: 27.06.2018].

[13] *Statement of financial accounting standards № 142 „Goodwil land other intangible assets",* https://www.fasb.org/summary/stsum142.shtml [access: 27.06.2018].

[14] *IAS 36 „Impairment of assets"*, https://www.iasplus.com/en/standards/ias/ias36 [access 27.06.2018].

exceeds the goodwill, the excess amount is distributed among other assets in proportion to the book value.

In IFRS 3, much attention is paid to the disclosure of information in the financial statements of goodwill of the company. In particular, it is necessary to substantiate its appearance. This requires disclosure of amounts recognized at the acquisition date for each class of assets and liabilities acquired by the company, as well as their carrying amount determined immediately before the merger. Describe the factors that led to the value that led to the recognition of goodwill. In particular, it is necessary to describe every intangible asset that was not recognized separately from goodwill, as well as explain the reasons for impossibility of a reliable estimate of the fair value of intangible assets.

In order for users of the financial statements to assess the change in the carrying amount of goodwill during the period, the entity should disclose information about the carrying amount of goodwill at the beginning and end of the period, indicating separately the gross amount and accumulated impairment losses at the beginning of the period, as well as information about impairment losses, recognized during the period. In the presence of negative goodwill, it is necessary to describe its properties and the amount recognized in the reporting.

The advantage of testing goodwill for depreciation without depreciation is the ability to recognize goodwill as long as it brings economic benefits to the company. In this case, the main advantage of amortization of goodwill without its testing for depreciation – simplicity and cheapness will not be realized. From the point of view of the complexity of accounting work to amortize the acquired goodwill incomparably easier – this is one of the undoubted benefits of depreciation.

There are critical remarks by contemporary scientists regarding goodwill testing for depreciation. For example, American professors K. Ramanna and R. Watts[15] note that such testing is based on the expectations of managers, which are inherently subjective and difficult to verify. Professor A. Beatty and J. Weber[16] (USA) tested the relationship between bonuses accrued management companies depending on the size of net income, and the amount recognized in the financial statements of impaired goodwill have found that most deferred depreciation in the coming years for the sake of personal gain of top managers. They also found that companies were inclined to recognize goodwill impairment losses in those years when their profits strongly exceeded the average market and when the CEO changed recently. When developing financial statements, companies do not always comply with accounting standards for displaying and disclosing information

[15] Gu F., Lev B., *Overpriced shares, Ill-advised acquisitions, and goodwill impairment*, „Accounting Review” 2011, Vol. 86, N 6, p. 1995-2022.

[16] A. Beatty, J. Weber, *Accounting discretion in the fair value estimates: an examination of SFAS 142 Goodwill Impairments*. „Journal of Accounting Research”, 2006, N. 44, p. 257-288.

in it. A non-transparent goodwill testing procedure for impairment can easily be the subject of manipulations: a company can recognize an impairment loss when it needs to reduce the gain or value of net assets and not recognize it when it needs to maintain the specified indicators.

Conclusions

In the framework of modern accounting, in our opinion, it is necessary to improve the methods of testing the acquired goodwill for depreciation than to talk about a radical change of this concept to another. Of all the proposed concepts for further accounting goodwill (immediate write-off, short-term write-offs, systematic long-term depreciation, testing for impairment), the latter most accurately discloses information about the present value of acquired goodwill in the financial statements, without diminishing its value, if it has not actually diminished.

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