

Methodical and Practical Approaches to Goodwill Valuation

O. Kurakova

Moscow State University of Civil Engineering
Yaroslavskoye sh. 26, Moscow, 129337, Russia
ks-home@mail.ru

A.Orlov

Moscow State University of Civil Engineering
Yaroslavskoye sh. 26, Moscow, 129337, Russia
ks-home@mail.ru

Abstract— With the development and stabilization of market relations in Russia and emergence of the financial market as a full-fledged segment of the economy, companies aimed at long-term and prosperous existence try to move to a new level of development, at which the company's goodwill becomes its most expensive asset. This approach based on the management of the value of companies is relevant to the ones that seek to enter the international market. Due to its formation and evaluation of the company's image became a challenging issue for Russian companies focused on the international market. The concept of goodwill and the immediacy of issues related to the inclusion of this component into the value of the enterprise are considered in this article. A comparative analysis of the Russian and international practice of goodwill accounting is carried out. An analysis of planned changes in Russian financial reporting, in particular, changes in the draft of new federal standards "Intangible Assets" is carried out. The main current methods for goodwill valuation are presented. A specific example of goodwill valuation in the banking sector is given. The analysis allowed to draw a conclusion that there are no unified approaches to the valuation and accounting of goodwill and there is a need for further adaptation of Russian standards for the purposes of bringing them in compliance with IAS/IFRS.

Keywords— *Goodwill, intangible assets, federal valuation standards, international financial reporting*

I. INTRODUCTION

With the development and stabilization of market relations in Russia and emergence of the financial market as a full-fledged segment of the economy, companies aimed at long-term and prosperous existence try to move to a new level of development, at which the company's goodwill becomes its most expensive asset [1-3]. This approach based on the management of the value of companies is relevant, first and foremost, to those ones that seek to enter the international market [4].

As for business, market processes of its purchase and sale are expressed in the form of merger, acquisition and absorption of companies [5-7]. At the same time the price of the transaction, namely the value of companies, is significantly affected by "business reputation" (the term adopted in the Russian Federation) or goodwill (the term adopted in international practice).

Companies seeking to have a good business reputation shall offer high-quality goods (works, services), have a strong management team and a developed marketing strategy. Availability of a regular customer base, established relationships with suppliers, low credit risks, and, of course, an established corporate culture are also of great importance.

So, it is obvious that the value of an organization taken as a single property complex differs from the aggregate value of its assets and liabilities. There is always a difference between them - it is goodwill.

Goodwill is usually created when a certain premium is paid to buy out a controlling block of shares in an enterprise. It can also be created when a bank buys a loan or another similar asset for the price that exceeds its estimated market value [8, 9].

For example, an enterprise that has an equity interest in another enterprise in the amount of 30% decides to acquire additional 30% to retain full control. The price of acquisition of shares of another enterprise amounts to 500 thousand rubles, whereas its real value (market price or a 30% share in the capital) is 300 thousand rubles. In this case goodwill will be 200 thousand rubles.

According to both international and Russian accounting standards, goodwill refers to intangible assets, but this accounting item has a feature that distinguishes it from other intangible assets - goodwill does not exist separately from the enterprise [10, 11].

Goodwill is an inalienable property that cannot be disposed of separately from the enterprise. It can not be an independent object of the transaction, since it does not belong to the company on the right of ownership.

According to IFRS 3 "Business Combinations" [12], goodwill is the difference between the price of an enterprise and the fair value of all its assets.

In accordance with Regulation of the Russian Federation No. 14/2007 "Intangible Assets Accounting" [9], goodwill is the difference between the price of an enterprise and the value of all its assets and liabilities on the balance sheet.

The difference can be either positive or negative. Positive business reputation should be considered as a supplement to

the price paid by the buyer in anticipation of future economic benefits related to the acquired unidentifiable assets and accounted as a separate inventory item. It should be noted that in the draft of new federal standards "Intangible Assets", the definition of goodwill was not modified and availability of business reputation is recognized only in the case of acquiring from other persons. Expenses of a company for independent creation of these assets are recognized as expenses of the period during which they were incurred.

Negative business reputation should be considered as a discount granted to the buyer due to the absence of factors of availability of stable buyers, reputation for quality, marketing and sales skills, business relations, management experience, staff qualifications, etc.

According to the Chart of Accounts, account 04 "Intangible Assets" is used to summarize information on the availability and movement of the organization's intangible assets. But before accepting intangible assets for accounting it is required to form their initial value on account 08 "Investments in Non-Current Assets".

In accordance with Russian laws, acquired goodwill relates to depreciable assets and is amortized over a period of twenty years (but not longer than the life of the organization).

Depreciation allocations on positive business reputation are determined linearly by uniform reduction of its initial cost.

Negative goodwill in full amount relates to the financial performance of the organization as other income.

In international practice intangible assets are accounted for in accordance with IFRS (IAS) 38 Intangible Assets [13].

II. METHODS

The main differences in the accounting of goodwill in Russian (RAR) and international (IFRS) practice are as follows.

The first is that, according to RAR, intangible assets should be used for a long period of time, that is, have a useful life of more than 12 months. IFRS does not provide for a time criteria for the recognition of intangible assets, but rather involves an asset-based approach.

The second difference is that, according to RAR, properly executed documents confirming the existence of the asset and the exclusive right of the company to intellectual property (patents, certificates and other documents) are required to recognize intangible assets. IAS 38 does not include any requirements for legal rights, since the main criterion is the ability to control future economic benefits from the use of intangible assets. As a result of the discrepancy between the definitions, there are a number of differences in recognition of certain intangible assets in accounting. For example, RAR 14/2007 as distinct from IAS 38 assigns organizational costs to such intangible assets.

In addition, in accordance with IAS 38, intangible assets with an indefinite useful life are not subject to depreciation, so goodwill cannot be assigned to depreciable assets.

In accordance with IAS 36 "Impairment of Assets" [14], a company shall test the intangible asset with an indefinite useful life for the purposes of impairment determination by comparing its recoverable amount to its carrying value. Therefore, goodwill is an asset that must be annually tested for impairment. Losses from goodwill impairment are written off to profit or loss [1, 15-17].

In accordance with IFRS, it is impossible to see the value of goodwill, on bookkeeping accounts, since it is accounted for as part of the value of shares. In the balance sheet (consolidated statements) this value appears only in the case of acquisition of a subsidiary or an associate, and the value of the parent's own business reputation is not reflected in the balance sheet. Goodwill is shown in consolidated statements of a group of companies, i.e. when the enterprise consolidates the balance sheet [18-20].

Let's consider an example.

An investment bank has the following balance (Table 1 and Table 2).

TABLE I. BANK'S BALANCE

| Assets '000 rubles | | Liabilities '000 rubles | |
|---|-------|----------------------------|-------|
| Liquid funds | 100 | Authorized fund | 500 |
| Investments in the capital of a subsidiary bank | 800 | Retained earnings | 500 |
| Other assets | 200 | Other liabilities | 100 |
| Total | 1,100 | Total | 1,100 |
| Subsidiary's bank balance: | | | |
| Liquid funds | 100 | Authorized fund | 500 |
| Loans | 800 | Retained earnings | 500 |
| Other assets | 200 | Other liabilities | 100 |
| Total | 1,100 | Total | 1,100 |

Let's assume that the investment bank has a 60% stake in the subsidiary bank acquired for 800 thousand rubles. 60% of shares amount to:

At nominal value - 300 thousand rubles.

Real value - 600 thousand rubles.

So, goodwill is 200 thousand rubles.

TABLE II. CONSOLIDATED BALANCE SHEET

| Items | | Items | |
|--------------|-------|--------------------|-------|
| Liquid funds | 200 | Authorized capital | 500 |
| Loans | 800 | Retained earnings | 500 |
| Goodwill | 200 | Minority interest | 400 |
| Other assets | 400 | Other liabilities | 200 |
| Total | 1,600 | Total | 1,600 |

In this case goodwill is defined as the difference between investments in equity in the parent bank and the share of the parent bank's participation in the subsidiary, i.e. 800 thousand rubles - $(0.6 * 1,000) = 200$ thousand rubles.

It should be noted that in case there are requirements and obligations between the parent and the subsidiary banks, such as granting of loans, provision of deposits, etc., these amounts shall also be excluded from the consolidated balance sheet, as well as amounts of income and expenditure for settlements between them shall be excluded from the consolidated profit and loss statement. However, the problem related to goodwill writing off arises. There are several solutions. The first and the simplest one is writing it off during the first year. But in case the value of goodwill is significant for the parent enterprise, writing it off for losses will ultimately affect the performance of the parent enterprise. In addition, the control block of shares is bought for the purposes of effective management of the subsidiary, which means getting more profit.

III. RESULTS

So, goodwill is paid by the parent enterprise for the purpose of getting a larger profit by the subsidiary, which should ultimately cover the value of goodwill.

Let's turn to our example again and imagine that the subsidiary bank will receive a profit of 300 thousand rubles next year and accrue dividends on it in the amount of 100 thousand rubles. At the same time balance sheets are as follows (Table 3 and Table 4):

TABLE III. INVESTMENT BANK BALANCE SHEET

| Items | | Items | |
|---|-----------|-------------------|-------|
| Liquid funds | 100 | Authorized fund | 700 |
| Loans | 500 | Retained earnings | 800 |
| Investments in the capital of a subsidiary bank | 800 | | |
| Other assets, including the subsidiary bank | 200 60 | Other liabilities | |
| Total | 1,600 | Total | 1,600 |

TABLE IV. INVESTMENT BANK BALANCE SHEET

| Items | Items | | |
|--------------|-------|---|-----------|
| Liquid | 300 | Authorized fund | 500 |
| Loans | 900 | Retained earnings | 700 |
| Other assets | 200 | Other liabilities, including the parent | 200 60 |
| Total | 1,400 | Total | 1,400 |

In this case the consolidated balance sheet will be (Table 5):

TABLE V. INVESTMENT BANK BALANCE SHEET

| Items | | Items | |
|--------------|-------|-------------------|-------|
| Liquid funds | 400 | Authorized fund | 700 |
| Loans | 1,400 | Retained earnings | 800 |
| Goodwill | 80 | Minority interest | 480 |
| Other assets | 340 | Other liabilities | 240 |
| Total | 2,220 | Total | 2,220 |

In this case goodwill is defined as the difference between investments in equity in the parent bank and the share of the parent bank's participation in the subsidiary, i.e. 800 thousand rubles - $(0.6 * 1,200) = 80$ thousand rubles.

Since the parent bank should forecast an increase in profit, it is not necessary to assign the entire amount of profits of the subsidiary bank to goodwill reduction. The bank can decide to apply the method of asset impairment (IAS 36).

A test for goodwill impairment is carried out according to the formula:

$$PV = FV * 1 / (1 + r)^n \quad (1)$$

where PV - present value of cash flows.

FV - future value of cash flows.

$1 / (1 + r)^n$ - discount factor.

r - interest rate on attracted or placed resources for a similar period.

n - the number of periods.

In accordance with international standards goodwill is calculated and accounted in several stages:

The total value of revaluation of balance sheet assets and liabilities before their current market value is determined.

The market value of net assets is determined.

Goodwill is calculated as the difference between the acquisition price and the market value of net assets.

The excess of the purchase price over the market value is shown in the balance sheet as an asset that is tested for impairment during the useful life period determined by the management of the company itself.

In case goodwill is negative, the difference between the market value and the purchase value of assets can be treated as deferred income.

And an important problem is goodwill valuation.

There is no single and universal methodology for goodwill valuation at the moment. The following main methods for goodwill quantitative valuation can be mentioned [8]:

- The method of surplus profit.
- The balance-normative method.
- The Edwards-Bell-Olson model (EBO).
- The method of surplus resources.
- The method based on the sales level indicator.

- The method based on cost accounting.
- The qualimetric method.
- The method that takes into account the company's market capitalization indicator.

The first two methods are most widely used in practice.

The first one involves valuation of goodwill as a source of additional revenue (the method of surplus profit). It is based on a direct comparison of profitability levels of the evaluated enterprise and other analogous enterprises in the industry followed by subsequent capitalization of that part of the difference between them, which is not explained by the impact of tangible assets.

The second approach is based on accounting of results of specific transactions. The value of the acquired business reputation is taken in the amount of the difference between the amount (balance-normative or accounting method) actually paid for the enterprise and the aggregate value of certain assets and liabilities of the enterprise recorded in the latest balance sheet.:

IV. CONCLUSION

It should be noted that due to intensive development of the economy and introduction of new technologies, competition increases at a high rate, companies find it increasingly difficult to maintain their positions in the market and positive goodwill helps them with this. In general, anything that helps a company to get more profit per unit of assets as compared to a similar company in the same sector of the economy can be goodwill.

Taking into account the analysis above, we can draw a conclusion that there are no unified approaches to goodwill valuation and accounting and there is a need for further adaptation of Russian standards for the purposes of bringing them in compliance with IFRS.

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