IS THERE A WAY TO MAKE GOODWILL A MORE SUITABLE SUBJECT OF THE COMPANY DECISION-MAKING?

[Existuje způsob, jak učinit goodwill vhodnějším pro účely manažerského rozhodování?]

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Abstract: The paper examines goodwill as a potential subject of management decision-making. It begins with a premise that although goodwill can be of a very high value it is often kept in books without much interest of a company management. This reflects the fact that goodwill emerges as a result of past events and is therefore in only a very limited way useful for company management, which is mostly concerned with a company's future rather than the past. The paper therefore identifies primary (i.e. internally generated) goodwill as a better subject of management than the secondary (i.e. purchased) goodwill. It introduces possible method of its valuation and proposes its allocation to individual cash generating units as a possible technique leading to valuable information to be used by management in managing a company's performance.

Keywords: allocation, goodwill valuation, primary goodwill, secondary goodwill.

JEL classification: M41

Doručeno redakci: 23.1.2017; Recenzováno: 1.2.2017; 6.2.2017; Schváleno k publikování: 31.5.2017

Introduction

Goodwill as an intangible asset is separately recognizable in financial statements under both International Financial Reporting Standards (IFRS) as well as Czech Accounting Standards (CAS), but its recognition is allowed only in a process of business combinations. However, following its identification and valuation the goodwill is then often kept in the books without much (if any) interest of a company management although its value is often relatively high compared to other assets. There may be multiple reasons for this, one of which is arguably the fact that before a business combination takes place the goodwill remains hidden from both internal stakeholders as well as external users of a company's financial statements. Companies also lack proper information about the value of its goodwill before a business combination takes place and further tools and guidance to identify the determinants of its value. Management thus pays an attention only to some specific tasks in order to comply with local and international accounting standards and legislation. These include performing regular goodwill impairment reviews and providing with all necessary disclosures in external reporting.

The goal of this paper therefore is to identify, explain and discuss possible framework that will introduce techniques in the process of the goodwill identification, valuation and management, suitable for the ordinary business practice. This should then increase the potential of such information to be more valuable for the use in the strategic management decision making, compared to relatively rigid techniques and processes allowed under currently generally accepted financial accounting and financial reporting standards.

1 Literature Review and Research Methodology

The term "goodwill" is often erroneously interpreted as the value by which a consideration given for net assets acquired through business combinations exceeds the net book value of these assets. However, this would do only as a proper interpretation of the "secondary goodwill" (often called purchased goodwill as well). Internally generated goodwill (referred to as primary goodwill in this paper) on the other hand often remains neglected probably because it cannot be legally recognized in financial statements under neither IFRS nor most other generally accepted accounting standards. Many articles thoroughly discuss the reasons for not recognizing the internally generated goodwill in company accounts (Ratiu, Tiron Todor 2013). Nevertheless, this concept is rarely new as this was common already in papers from between the two world wars (Walker 1938). Most of the current discourse is aimed to discuss the correct treatment of the secondary goodwill in financial statements, including its proper presentation and discussions about impairment review and/or amortization (Kimbro, Xu 2016; Sacui 2016; Sherill 2016; Hulzen, Alfonso, Georgakopoulos, Sotiropoulous 2011). Some others try to identify and describe the core drivers of the goodwill that includes the internally generated goodwill as well. The most commonly named drivers are e.g. synergies within the company, research and development expenditures and marketing campaign costs (Sacui 2016). However, its valuation may not only be based on some specific costs incurred. As current research suggests, there are many more approaches to goodwill valuation, such as market approach methods (namely "the residual from purchase price method" or "the sales comparison method") or income approach methods (Reilly 2015).

However, not many researchers go further to explain possible means of identification and proper valuation of the primary goodwill suitable for the company management decision-making purposes. The mere question of identification of the primary goodwill as well as a possible use of information about the value of a company's primary goodwill for managerial purposes is therefore clearly a very topical issue for further analysis.

Following up on the literature review in order to meet the goals of this paper as set in the section 1 I will firstly discuss the limitations that arise from the need of identification and valuation goodwill strictly in line with generally accepted accounting standards. Bearing these limitations in mind, I shall further continue with a proposal of alternative techniques and tools to allow managers get an alternative information about the goodwill and its valuation, which could be more relevant and suitable for incorporation to management decision-making process. This paper is therefore composed as an extended analysis based on the current state of knowledge and the business practice in this area. The core findings of this research are presented in the following sections of this paper.

2 Goodwill as an Intangible Asset

Goodwill is undoubtedly one of the most controversial assets that can be found in financial statements prepared under both IFRS and CAS. It is recognizable only as a product of business combinations and unlike other assets it cannot be reliably separated from the company and sold in exchange of money or any other consideration. I should also note that it is even doubtful whether it fulfils all the recognition criteria normally set on intangible assets.

There are many definitions of goodwill. We can cite one of the most representative that should help us to understand better the nature of this intangible asset:

„Goodwill is an asset that represents future economic benefits arising from other assets in business combination which cannot be individually identified and recognized. This economic benefit can as well result from synergies from merging assets of a parent company and its purchased subsidiary." (Hornická, Vašek et al. 2012, p. 45).

We can therefore conclude that goodwill is an asset that is created throughout the existence of a company and represents an aggregate of those phenomena that are immanent to the company but were not recognized in books as any other asset. In line with both CAS and IFRS the goodwill can be quantified only during business combination as a difference between consideration transferred and the value of net assets purchased. Goodwill recognized this way can only then be shown as an intangible (fixed) asset within the Statement of Financial Position (SoFP).

Such goodwill includes two main components – primary, that includes both internal, and external components of goodwill, which are present in a company before its participation in business combinations and a goodwill resulting from synergies with other group companies. Aggregation of these two elements of goodwill, i.e. the intangible asset recognizable in financial statements, is often referred to as a secondary goodwill. We can therefore say that the primary goodwill is a subset of the secondary goodwill and is per definition lower (in monetary terms).

3 Goodwill as a Potential Subject of Management Decision-making

Following up on definitions of both primary and secondary goodwill, I will now discuss possible options and limitations of goodwill management. I will firstly consider secondary goodwill, where there are no such significant disputes over its valuation. Only after that, I will follow up with the discussion of the primary goodwill, because in this case I shall also discuss possible techniques for its indicative valuation. This will naturally emphasize different requirements in terms of quality and quantity of underlying data and methodology. Finally, I will introduce the concept of goodwill allocation as a subsequent technique to increase the usability of information about the value of the recognized primary goodwill.

3.1 Can the Secondary Goodwill Be Reasonably Used in Management Decision-making?

As we have discussed earlier, financial accounting deals mostly with the secondary goodwill. Following its initial recognition in financial statements, it maintains its value in the books and is hardly paid any attention to until the end of a fiscal year, when the management needs to reconsider its valuation. A requirement to test goodwill for its possible impairment is set by IAS 36 (impairment of assets). Per this standard all accounting units are obliged to test the goodwill for impairment at least annually (not necessarily at the end of the accounting period), and any other time should there be any indications of events that may lead to a decrease of value of the goodwill. The impairment testing itself has several steps:

a) In the first step we need to allocate goodwill to individual cash-generating units or to groups of cash-generating units, which in some way benefit from the synergy effect created in business combination,

b) In the second step we set a referential value, which will then be compared with a net book value (NBV) of the cash-generating unit (CGU). This referential value is the higher of the fair value of the CGU less costs to sell (i.e. its net selling prize) if any and a net present value of its future cash-flows,

c) In the third step, after determining the referential value, we compare this to the current NBV of the goodwill. If the identified referential value is higher than NBV the test ends in this phase and the goodwill remains unimpaired. The impairment is recognized in an amount for which the NBV exceeds the identified referential value and is booked accordingly.

From the process above the most relevant part for this paper is the first phase, which requires us to allocate the goodwill to individual CGUs. Here we are using a technique much more typical for management than for financial accounting, although normally we face a necessity (or a need) to allocate costs or revenue items, rather than allocate assets, in this case goodwill. Partially it is caused by a fact mentioned by Zelenka (2006), that „a frequent myth, often accepted by the experts is, that goodwill is only attributable to the company as a whole, i.e. that the carrier of the "advantages" represented by goodwill is solely the company itself." The allocation of goodwill to CGUs can therefore be initially regarded with distrust and a methodological confusion. We can further justify the allocation of goodwill to individual business structures by stating a fact that „if there is to exist a future economic benefit from some asset, including goodwill, and a company controls this asset, naturally there has to exist some subject of this control. For goodwill this control has therefore got to be ensured in relation with some other assets." (Zelenka 2006).

In line with this methodology of (secondary) goodwill allocation, we are able to identify those company structures, which are accountable for the excess of value of the company (accounting unit) over the value of its identifiable net assets as at the date of the acquisition. However, this implicitly also includes a secondary problem that the goodwill allocated in this manner is an asset that emerged as a result of past events (actions, influences, processes) and is therefore in only a very limited way of any use for company management, which is mostly concerned with a company's future rather than past.

To sum up, acquiring information about allocation of the purchased goodwill may be essential in order to be able to meet the requirement to test the goodwill for its possible impairment. However, this is not very useful for its management as an asset. In books it is always kept either in the gross value identified during acquisition or in the impaired value based on the value determined during the impairment test. For the management purpose it therefore seems to be much more reasonable to be able to identify and control the primary goodwill instead.

We can thus ask ourselves, whether there are some other decision-making problems linked to primary goodwill instead that can be tackled using the information of assignment of goodwill to hierarchically lower company structures and that are not necessarily directly linked to some regulatory or legislative requirements set on financial reporting. Companies obviously emphasize much more the management of other assets, whether these are either fixed (such as plants or equipment), current assets (such as inventory or trade receivables) or financial asset (such as cash) then goodwill. However, allocation of goodwill can introduce the management to valuable information of what company structures are (based on the best estimate) its originators. In the next chapter, I will therefore follow up on this conclusion with more focus put on primary goodwill instead, as possibly the more suitable alternative to incorporate into the company's management decision-making process.

3.2 Introducing the Primary Goodwill to the Management Decision-making

As already mentioned in previous sections, primary goodwill arises from positive external and internal forces that influence the company and is a subset of a secondary goodwill, which on top of that also includes synergies arising from business combinations. However, primary goodwill is not paid such a close attention to, mostly because it cannot be legally recognized in financial statements. There are multiple reasons why it is justifiable not to do so. The most significant probably is that it cannot be reliably appraised and thus its recognition might materially distort true and fair representation of a financial position of an accounting unit. Nevertheless, it can be very reasonable to concentrate on it further and manage it as far as it directly influences the company's value, thus the fortune of the company's owners as well.

This creates a problem that we did not have to deal with when we were identifying the secondary goodwill in the previous section. That is a need to apprise the primary goodwill so that in the next stage it is possible to determine its change of value (in this case both increase and decrease are acceptable) and find the determinants of this development as inputs for its proper subsequent management.

There are at least two approaches available for the primary goodwill valuation, the second of which is further discussed in this paper. These are the following two:

a) Valuation of the primary goodwill based on costs incurred by the accounting unit on individual components of the goodwill, and
b) Valuation of the primary goodwill as a difference between the value of an entity's net assets and valuation of the entity (or part of the entity) itself.

The first approach is based on an underlying assumption that some costs incurred during the accounting period have an impact on future economic benefits of a company. This way they constantly create assets not recognized in financial statements. Such costs include expenses on activities such as brand building, investments to increase employees' qualification, creating and maintaining specific know-how, good supplier relations etc. Illustrative list of such cost items might include the following:

- Costs on education and training of employees and management
- Marketing and promotion costs
- Quality control
- Costs on implementation and management of key internal systems and controls

The list above obviously is not comprehensive, as far as it is not at all certain which costs and of which amount contribute to the goodwill, which also is probably the biggest constraint behind this alternative. There exists only a very vague relationship between the costs actually incurred in the prior and current accounting period for e.g. marketing, public relations or training and their actual contribution to goodwill (i.e. materialized intangible representation of future benefits). It is also very difficult if not virtually impossible to quantify in this manner the external (out of the company) components of the primary goodwill.

The second method proposed is much more similar to valuation of the secondary goodwill during acquisitions. However, in this case the acquisition transaction has to be substituted by some method of company or asset valuation. This valuation method cannot be under any circumstance a market method, such as market capitalization, or some form of Earnings Before Interest Taxation Depreciation and Amortization (EBITDA) multiplier, since such valuation implicitly includes the secondary goodwill, which we aim to remove altogether from our primary goodwill valuation. For this purpose, I believe an income-based valuation method would be much more appropriate. This could moreover be used internally in almost any profit-based company, excluding companies undergoing liquidation or new companies with only a short business history. Nevertheless, for such companies the information about the value of internal goodwill would still be of only a limited if any use at all.

There are many non-market based valuation methods available. These however differentiate more in the calculation methodology rather than in the result itself. As far as a detailed analysis of various valuation methods is not the main subject of this paper, I will limit this to stating that in the rest of the paper I will use the method most commonly used in business practice, which is *discounted cash-flow (DCF) to entity* method.

Using the method of DCF to entity, a company's value is determined based on this formula:

$$H = \sum_{t=1}^{T} \left(\frac{\mathrm{FCFFt}}{(1 + \mathrm{WACC})\mathrm{t}} \right) + \frac{PH}{(1 + WACC)t} \qquad (1)$$

where

H – is the value of a company based on DCF to entity valuation method

FCFF – is the first phase free cash-flow to firm

WACC – is the discount rate set as weighted average cost of capital

PH – is the continuous value of the company in the second phase

t – is the length of the first phase in years

For a detailed description and critical analysis of this valuation method refer to e.g. monographies written by Mařík (Mařík 2011a; Mařík 2011b). For this paper it is mainly important that this method allows us to determine a value of a company without including synergies with any other companies to our valuation or without unintentionally eliminating external influences on the valuation.

An important attribute of this valuation is the need to determine the free cash flow to firm (FCFF) for the first and second phase. It means that we need to create as realistic plan (medium-term budget) as possible for the period of minimum three, but if possible even five to ten years. Based on the created cash-flow budget (and after required adjustments to arrive to the FCFF for valuation purpose) we are then able to use the formula above to determine the basis for the primary goodwill valuation. By subtracting the value of this valuation basis (here $Z_{GW(prim)}$) by a value of company's net assets (NA) we then find the indicative value of a company's internal goodwill (GW_{Int}). The NA used in this calculation should be valued at its fair value. The formula that represents this relationship can be written as follows:

$$GW_{Int} = Z_{GW(prim)} - NA \qquad (2)$$

This formula clearly indicates that if the value of the valuation basis determined using the cash flow plan exceeds the value of company’s net assets, the result is a positive primary goodwill, unaffected by any synergies with any other entities. If the value of net assets exceeds the valuation basis, it indicates an existence of a negative goodwill. The value calculated this way can then be used by managers and shareholders as indicative information about current and up to date value of the primary goodwill of the entity.

To be able to use the newly acquired information about the primary goodwill for management purposes, we will need to identify its originators. It is therefore key to discuss, whether it is possible and useful to allocate the goodwill to pre-defined intra-company/intra-group structures.

Here we can find analogies with International Accounting Standard IAS 36 – Impairment of Assets, which describes the technique of allocation of assets, which is also the goodwill, to CGUs in order to test its possible impairment. CGU here is defined as „the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.“ (Nařízení komise ES 2008). IAS/IFRS standards thus indirectly identify the CGUs as carriers of the goodwill, although under their approach naturally the secondary goodwill only. I also need to note that these CGUs are only such parts of a company that provide outputs (goods, products, services, etc.) potentially relevant to external customers. As discussed by Dvořáková, „as an independent CGU we have to identify only those assets (or group of assets), outputs of which can be sold separately and for which an active market exists, with disregard to whether this sale has actually taken place or not.“ (Dvořáková 2011, p. 43). It is therefore useful for the company to have an internally established system of divisions, so that it can determine market value of outputs of every one of them. This calculated value should be a market value not a value calculated internally by other accounting techniques for setting internal transfer prices. After the market value of such outputs was quantified, the primary goodwill can be allocated based on weighted rate of which individual departments contribute to the sum of the market value of the total company output.

Sometimes it will not be possible to determine correctly the market value of an output of some division. This could happen either because there is no active market for it or because the outputs can be valued only together with outputs of some other division in a shared production process. In such case, these divisions should not be identified as separate CGUs in the first place and the primary goodwill should be allocated to hierarchically higher company level, i.e. to units, that can be themselves considered as cash generating. These units can be e.g. groups of divisions or departments that as a whole form a coherent economic cycle or even individual accounting units (if the internal goodwill is calculated for a group of accounting units). This process does not lead to allocation of goodwill to the hierarchically lowest company levels possible, however as remarked by Zelenka, „as far as goal congruence between the hierarchically lowest company levels with the top company goals is most prominent at the top company levels and often absolutely unclear at the elementary levels of a company structure, we can assume, that goodwill should be allocated rather to this higher level.“ (Zelenka 2006, p. 109). Company (group of companies) should then allocate the internal goodwill in the re-calculated amounts to these divisions or accounting units. This will enable the management not only to find the value of the internally generated goodwill and monitor its development over time, but also to identify the potential originators of this rather perishable asset.

Conclusion

This paper in line with its goals set in the introductory section identified, explained and discussed a possible framework that allows better to incorporate an information of a value of a goodwill to a company's management decision making. This was made in contrast with identification and valuation of the secondary goodwill allowed in line with most generally accepted accounting standards. The paper clearly identifies the primary goodwill as the more suitable subject for company decision-making and proposes a process of its valuation and further allocation to increase the value of such information for the company management.

I discussed that it is potentially of a very good use to start identifying and determining the amount of primary goodwill in standard business practice at a company level, or at a level of individual divisions and sub-divisions, if these are independent, decentralized units with a relatively closed business cycle. The companies are then able to identify and appraise internal goodwill on a yearly or more frequent basis and monitor the changes in its value over the time using standard business and asset valuation techniques, as well as its allocation among individual CGUs. This information can thus become a suitable basis for company management to understand better the existence and determinants of this asset normally not recognized in balance sheet (the value of which can sometimes be close to or even exceed the value of assets recognized in financial statements). Based on this updated information the management can adjust its decision-making accordingly.

However, considering the limitations I have found in the process of goodwill allocation I can conclude, that it is not reasonable to yield to temptation to allocate the identified primary goodwill to hierarchically lowest company levels possible. Immanent and often very important component of any goodwill are synergies among individual components of a company as well as CGUs, which itself are not useful and suitable for allocation.

Based on the framework introduced and discussed in this paper I propose a deeper analysis on what business decisions and to what extent could benefit the most from the newly identified information of the primary goodwill value and its allocation as a possible topic for further research in the area of goodwill and its management.

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