

THE ENTERPRISE'S GOODWILL AS A RESULT OF INVESTMENTS

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Key words: business reputation, investments, goodwill and methods of its estimation, intangible assets, unencumbered assets

This article describes goodwill as a result of investments, the process of its forming and possible ways of estimation. Here are described different approaches, given by the international standards and the Russian rules of accounting as well. The analysis of these practices made the author come to some personal conclusions about the development of goodwill position, evaluation and depreciation which are also given in the article.

Goodwill according to applicable Russian legislation can be defined as the difference between the purchase price of organizations (like acquired property complex as a whole) and the value of its assets and liabilities on the balance sheet.

The positive business reputation of the organization should be regarded as a premium to the price paid by the buyer in anticipation of future economic benefits, and incorporated as a separate inventory facility.

Negative goodwill should be seen as a discount on the price offered by a buyer as the result of the lack of stable customers availability, the reputation of quality, marketing skills, business contacts, management experience, qualification level of personnel, etc., and recorded as future periods income.

The International Standards call the business reputation of the company the "price of the company" or "goodwill". For the domestic economy the definition of "goodwill" is still little used in practice, so we believe it is necessary to clarify some issues related to this concept¹.

Goodwill suits the definition of an asset, because:

- ◆ it occurs at the time of purchase of a property complex, acquired for the purpose of obtaining benefits;
- ◆ it is measured like a difference between the cost of acquisition and net assets (present value) of the company;
- ◆ it allows to bring the net? assets of the company to market its price, which is impossible without the consolidation of its accounts;
- ◆ it is reliable - the cost of acquisition of a property complex are proved by documentation.

Consequently, goodwill suits the criteria for determining asset and should be recognized as as-

set, in exactly the same way as the material costs. Thus, the cost of acquisition of part of the excess must be capitalized and their cost should be amortized over a sufficiently long period of time.

Goodwill has a special place in the composition of non-material actives. It is defined as the excess funds spent on the purchase of a property complex, over the assessment of its net assets.

However, the numerical value of goodwill rather than its definition. In principle, its appointment is to bring net assets (present value) to the market value of the enterprise, which occurs only when it is sold.

An alternative way to the use goodwill may be revaluation of assets acquired businesses with a purpose of bringing its costs to market value. However, the process is so complicated that it is barely often reasonable. In addition, "price of the company" may depend on fluctuations in demand for its products or accidentally opened and previously unknown resources, etc., which increase the "price of the company", regardless of the market value of its assets.

Consequently, "the price of the company" will almost always be different from the market value of its assets as well.

It is also should be mentioned that "goodwill" appears only as a result of the investment process for the acquisition of corporate control or significant influence over the associates. It can not be identified with the definition of "the price of the company". Since the last one is much broader and could be used, for example, for the current (market) evaluation of the enterprise, if it is provided in its accounting policies.

So, goodwill is capitalized part of investment costs for the acquisition of corporate control or significant influence over invested company, de-

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defined as the difference between the total amount and value of net assets (all or the share) of the acquired organization that can not be attributed to the value of any particular asset.

In domestic practice in acquiring companies it is often manifested a negative goodwill. But this does not explain the effectiveness of the buying company managers, but rather the inadequacy of Russian legislation. This way a lot of businesses were brought to bankruptcy before had been acquired as a result of acquisitions.

As a result of the purchase price was considerably lower than the amount of their own capital. So here should appear a negative goodwill. However, in corporate structures that does not occur. The main reason it is the imperfections of current legislation. Assessment of goodwill is primarily relevant only to investors because its actual value (in which it is reflected on the balance sheet) is a clear numerical value. Investors also should know the limited level of the costs exceed on acquisition over the net assets acquired. In the world practice there are three main approaches to determine its value:

1. Estimation of the reputation of the company.
2. The current discounted valuation difference between the current profits and expected profits after the acquisition.
3. Residual value, which represents the excess value of the enterprise as a whole over the totality of its estimates of net tangible and intangible assets.

Consider these approaches in detail.

Estimation of the reputation of the company. It is often believed that the goodwill can be explained by the profitable business contracts of the company, its friendly relations between staff and a high reputation among customers. The amount of prices excess, for which the enterprise can be sold, over the total value of all assets is a fee for these intangible dignity of firms that have established its previous owners.

This approach assumes that this amount can be recorded as a separate asset of the company.

Ongoing assessment of the expected discounted "profit excess". This assessment of goodwill is possible only by the investor, as far as it is defined by its projections of future cash flows, profitability of investments and individual risk factors.

However, none of investors can apportion the value of the company as a whole to individual tangible and intangible assets of the company.

Residual value. The goodwill estimation based on the residual value considers a partly capitaliza-

tion of firm's assessing that can not be attributed to the value of any particular asset. This is perhaps the most economically proved definition of goodwill.

Methods of assessing the business reputation depend on two factors: the cost of buying and net assets of acquired businesses.

Assessing the business reputation of the amount of net assets is quite understandable, although net assets as an indicator is a new concept for Russian enterprises. Its emergence is linked to the introduction of legal documents that define requirements of comparing net assets with a registered value of the authorized capital. This figure is used primarily in assessing the possible elimination of joint-stock company, as well as in determining the share of property belonging to the depositor in the charter capital by its withdrawal from society. However, no legislation shows that this figure is the basis for evaluating investments in the enterprise.

Net assets of an enterprise can be calculated using the formula:

$$NA = A - BC,$$

where NA - net assets; A - the sum non-capital and capital assets; BC - borrowed capital.

If the value of investments will be higher or lower than the proportionate share of net assets, calculated on the date of purchase of a property complex, it must be aligned with it through the recognition of article "goodwill"².

So, the buying of the company must be taken into account with the historical cost of its assets equal to the amount paid by cash or cash equivalents at the date of acquisition, or other relief for the purchase, given by the buyer in exchange for control of the net assets of another company, plus any costs directly related to the purchase.

Some acquired assets and liabilities should be recognized separately at the date of purchase, when:

- ◆ there is a possibility that any related future economic benefits will be gained or lost by buyer;
- ◆ There is a reliable measure of their initial and fair value for the buyer.

Acquired assets and liabilities, suitable to these criteria, called identifiable assets and liabilities in IFRS 3. A part of the bought assets and liabilities that do not meet these criteria for recognition, is a resultant impact on the value of positive and negative goodwill arising upon the acquisition, because it is defined as the depreciated value of the purchase after the acceptance of identifiable assets and liabilities.

IFRS considers two methods of the distribution of the original cost of purchase:

1. Normative method. The assets and liabilities recognized in accordance with the criteria should be estimated according to:

- ◆ The fair value of identifiable assets and liabilities acquired at the date of the transaction exchange, the amount of participation of the buyer received in exchange transactions;

- ◆ Minority interest in the balance sheet value of assets and liabilities of subsidiary companies before purchase.

The initial purchase price is allocated to the assets and liabilities recognized in accordance with the mentioned criteria at their fair value at the date of the transaction exchange. However, the initial purchase price applies only to identifiable assets and liabilities acquired by the buyer. Consequently, when the buyer acquires not all the shares of another company, the formed share of minority interest reflected as part of the book value of net assets of companies belonging to minorities. This is happening because the share of minorities is not a part of exchange operations in the acquisition.

2. An authorized alternative method. The assets and liabilities recognized in accordance with the criteria should be estimated by their fair value at the date of purchase. The share of assets and liabilities should be reflected as part of the fair value of assets and liabilities belonging to minorities recognized in accordance with the criteria.

Under this method, the net identifiable assets over which the buyer gained the control, are shown at their fair value, irrespective of whether the buyer has acquired all or part of the capital of another company or acquired assets directly. Consequently, the percentage of minorities is shown as the same part of the fair value of identifiable net assets of a subsidiary company owned by a minority, that is generally true.

Another interesting and unresolved issue is the depreciation of the goodwill. According to Russian standard of accounting 14/2007 acquired goodwill should be depreciated during 20 years (but not more than the life of the organization). Depreciation charges for a positive business reputation of the organization are reflected in the accounting by a proportional reduction of its original value.

Negative goodwill applies equally to the financial results of the organization as miscellaneous income.

This question is shown more detailed in the IFRS 3 "Business Combinations". In calculating of

the period of use of goodwill the company recommends to take into account several factors:

- ◆ The existence of the organization, but not more than 20 years in the future;

- ◆ Market factors associated with obsolescence and the fall in demand for products made by the newly acquired assets: the impact of competition;

- ◆ The expected work period of key professionals and teams;

- ◆ The impact of legislative and contractual conditions on length of service.

As an intangible asset (goodwill) identified as unplanned costs, these costs are capitalized and subsequently should be depreciated just as in the purchase of fixed assets.

Depreciation of negative goodwill. Methods of IFRS consist the reflection of the negative goodwill reflected in the composition of retained earnings of acquiring companies or in the consolidated reserves of the consolidated group of companies. This approach is very simple, but not enough economically justified, as it contradicts the notion of profit.

Operating profit is the result of the sale, and not the result of the acquisition. The cost of an asset - this is the result of the acquisition, rather than the proposed profits. Profit may arise only from the use of the asset. Therefore, in this case we can speak only of the income of future periods and in their composition reflect the negative goodwill with the subsequent transfer value at the expense of "Gains and losses" and incorporate it into the composition of retained earnings (which can not be distributed until the elimination of the company).

The cancellation of negative goodwill at the expense of additional capital would be more reasonable, as the emergence of negative goodwill is nothing else but a declining of the asset value. And why, in this case did not draw a parallel with the revaluation of fixed assets derived from the additional capital, although the theoretical justification for such a solution is not perfect, it is not worse and even better than the concept of retained earnings, which can not be distributed³.

¹ International Financial Reporting Standards. M.: Askery. ACCA, 2008.

² R. Braly, S. Maeyrs. Corporate finance. John Willey & Sons. Inc., 2007.

³ A. Damodaran. Investment valuation. Tools and techniques for determining the value of any asset. Second edition. John Willey & Sons. Inc., 2007.