BUSINESS AMALGAMATION

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The term "goodwill" is resulted from various considered references. The features of the term distinguishing its "traditional" non-material actives are described. The formula determining depreciation of goodwill is resulted. Methods of recognition goodwill are described.

The process of business amalgamation, buying and takeovers has become essential in the modern world; with all this it is going on the value of a company is highly influenced by its business reputation, the term accepted in the Russian Federation, or so-called goodwill - the one of the international standards. If a company has an adequate quality of its production, a good staff of managers and efficient employees, a developed marketing strategy, a loyal clientele, established relationships with suppliers, high credit activities, a favorable location and a corporate culture, it becomes quite obvious that the cost of the company as a material complex is different from the cost of its assets and liabilities. And such a disparity is the goodwill itself.

According to IAS 3 "Company Amalgamation", the goodwill is the disparity between the purchasing power of the organization and the fair value of all of its available assets. Accordingly, the Accounting Statute 14/2000 "The calculation of the Intangible Assets" defines the business reputation as a disparity between the purchasing power of an organization as the whole material complex and the cost of all company's assets and liabilities in terms of its balance sheet.

The customer determines the purchasing power of the organization as a totality of the fair value of available assets of the company being purchased on the date of the purchase and any expenses connected with the amalgamation. The general administration costs, liabilities cost, the cost of shared tools output and prospective costs connected with the amalgamation are not included in amalgamation costs.

The estimation of assets and liabilities of the company being purchased is made according to their fair cost on the date of the purchase and includes the following:

♦ current market prices for the financial tools circulating on the active markets;

♦ the assessed value considering the relations between the share price and the income together with the dividend income and prospective progression for the the financial tools that do not circulate on the active markets;

♦ the capitalized value determined by the current interest rates with the deduction of dubious debts and recovery liabilities sums for the long-term accounts receivable and other identifiable assets;

♦ selling prices with the deduction of the sale expenditure for the finished commodity and the goods assigned for reselling;

♦ selling prices of the finished commodity less the costs for the completion of the production, costs on selling for the unfinished production;

♦ the current cost for buying analogous raw materials;

♦ the market value for acres, buildings, machines and equipment;

♦ prices on the active market, and in case of is absence - the ones basing on the expenses the buyer would suffer when making a deal with an independent party (in accordance with IAS 38 "Intangible assets") for intangible assets;

♦ the current cost for fixed liabilities and awards of the employees less the fair price of the pension plan assets for the net wealth and pension plan liabilities with fixed payments;

♦ tax remissions connected with the taxation losses and taxes to be paid in compliance with IAS 12 "Tax and profit", accepted considering the prospects of the amalgamated company taxation for the tax assets and liabilities;

♦ the capitalized value of liabilities determined by using the corresponding current interest rates for credit liabilities, notes payable, long-term liabilities, the advances received and other demands;

♦ the capitalized value for the financial tools of paying off the liabilities determined by using the

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corresponding current interest rates for contractor's agreement, onerous contracts and other identifiable liabilities of the company being purchased;

♦ sums required to the third party for assuming some contingent liabilities for contingent liabilities.

According to N.A. Makushina, the goodwill is a subtle border between the creative work and fraud in accounting, that underlines the role of a correct interpretation of this category for the users of financial accounting [N.A. Makushina. Method Journal "IAS and ISA in a Credit Organization", № 3/2008].

Consequently, the chief task of any accountant during the amalgamation is the explanation of the disparity between the purchase price of the organization and the fair cost of its net wealth. This also includes its decomposition into meaningful parts that implies revaluation of the net wealth at the fair price. The intangible assets such as as trade marks, Internet domains, client bases and other assets which have not been registered in the balance of the organization being purchased (providing they can be estimated on the date of the purchase) can be singled out from the disparity mentioned above. In addition IAS 3 requires the adoption of contingent liabilities that will influence the goodwill cost.

According to RSA and IAS the goodwill or business reputation refers to the intangible assets. However, that object of accounting has a wide range of peculiarities distinguishing it from traditional intangible assets:

♦ the business reputation does not exist without the organization. This is inalienable property that cannot be handled outside the organization. Without being the property of the company it cannot be the independent target of the contract;

♦ undoubtedly, the business reputation has no material form while other intangible assets have one: trade marks have a graphic presentation, firm-names and licenses registered officially, know-how is testified by some technical documentation;

♦ all intangible assets are registered in accounting at their original price, i.e. the sum of actual expenses connected with buying, or in some other way depending on payment type. At the same time the value indicator of the business reputation is rather conditional. In accounts of some British companies one can find an article "The Business Reputation" which states a symbolic sum of 1 & (with the balance indicator marked 1000&). That means that the reputation still exists or might have existed but is not defined or written off;

♦ intangible assets are used for a long period of time during which their cost is monthly transferred to the production made or services rendered by charging them with amortization. At that the original cost of intangible assets in the current account is not subject to any changes, excepting the cases stated by RF legislation; but they are registered in the balance at their residual value. The Business reputation cost can be "written off" or discharged but even in that cases the organization does not lose the reputation itself. In view of international standards of accounting, the goodwill as well as intangible assets are registered in the current accounting at their original price and in the balance - at their residual value. Nevertheless, there is a tendency of goodwill revaluation in the current accounting. That fact is testified by a new standard adopted in the USA № 142 "Accounting of Goodwill and Intangible Assets". It abolishes the amortization and prescribes the annual analysis and revaluation of the goodwill together with discharging the discounts of company expenses. It is not inconceivable that in the future this method will be adopted and recommended for the use by the IAS Commission. In Russia the goodwill was calculated by residual value in the current accounting as well as in the balance till recently. Thus, the Russian Ministry of Finance in its Letter from 23.12.92 № 17 "On presentation of operations connected with organization privatizing in accounting" recommended to charge the business reputation monthly during ten-years' period (but no more than the period of a company functioning) off the intangible assets omitting Account 05 "The amortization of intangible assets".

IAS 38 "Intangible assets" defines the asset as "the resource controlled by the organization as a result of passed events aimed at receiving economic benefit in the future". According to this standard the adoption of intangible assets is based on the general principle applied to expenses suffered originally for the purchase or creation an intangible asset by internal means, and also to those suffered as a result of its addition, substitution of its parts or its maintenance.

The resource corresponding to the definition of an intangible asset is acknowledged in accounting providing:

♦ there is a good chance of getting the prospective economic benefit from the assets;

♦ the assets cost are amenable to reliable estimation.

In terms of IAS 3 the goodwill is the prospective benefits defined by those assets of the purchased company which cannot be separated from the others. The period of their validity is beyond the definition. Due to that the method of the constant amortization cannot be applied to them.

According to IAS 36 "Assets Devaluation", the goodwill is an asset which must be annually tested in order to check the possible devaluation. The devaluation test is conducted by the formula:

$$PV = FV*1/(1+r)n,$$

where PV - the current cost of monetary flows; FV - the prospective cost of monetary flows; 1/(1+r)n - the discount coefficient; r - the interest rate of the resources attracted and distributed for an analogous period; n - the number of periods.

However, in accordance with the Accounting Statute 14/2000 "the acquired business reputation of the organization is amortized within the twenty-years' period". The negative business reputation of the organization is equally distributed among the financial results of the given organization as other profit.

In case when the fair cost of the identifiable assets is higher than the price of the purchase, the disparity is called the negative goodwill or bad will which is registered in accounting as a profit on the account of assets and liabilities within the current period.

The negative goodwill may arise due to overstating the assets cost, understating the liabilities cost or inadequate awareness of the company real cost.

In the event when the negative goodwill appeared it is necessary to reevaluate repeatedly all identifiable assets, liabilities and contingent liabilities of the organization being purchased and the expenses on the amalgamation.

In our view it is very difficult to evaluate the lifetime of any organization, and consequently the devaluation test will provide the more reliable estimation of the business reputation cost.

The calculation and accounting of the goodwill presupposes several stages:

♦ defining the total quantity of the book cost of assets and liabilities after-estimation up to their current market value;

♦ defining the market value of net assets;

♦ calculating the goodwill as a disparity between the purchase price and the market value of net assets;

♦ the excess of the purchase price over the market value is noted in the balance as an asset tested for devaluation within the durability period determined by the board of the company;

♦ in case of the negative goodwill the disparity between the market and purchase value of assets is necessarily taken into account in the assets of the current period.

One of the major problems is the estimation of the goodwill cost. That figure appears in the consolidated balance only in case of purchasing a filial or associated organization, and the cost of the parent company business reputation is not registered in the balance.

There are two methods of the goodwill acknowledgment:

♦ the method of full goodwill;

♦ the method of acquired goodwill.

There is no difficulty in defining the goodwill when the company buys 100 % of another company in the course of one deal. In that case the purchasing company includes all assets and liabilities together with the goodwill at their fair cost in the consolidated accounting on the date of the purchase.

However, if the company buys less than 100 % of another company, there arises a question about measuring of assets and liabilities acknowledged in the consolidated financial accounting at their full fair cost. That leads to a problem of the goodwill acknowledgment. Usually only the purchased goodwill is considered in practice. In the west practice there is an approach of reflecting the purchase of the company less than 100 % . It consists of single-step expense accumulation of every purchase at the moment of the purchase and afterwards the acknowledgment of additional goodwill, acquired after the amalgamation. That in its turn does not correspond to the principle of assets and liabilities accounting acquired by the company at their full fair cost on the date of the purchase. This practice is also incompatible with the principle according to which the parent company must include all assets and liabilities of its filial companies into the consolidated financial accounting. That is why it is necessary to acknowledge the whole goodwill of the purchased company including the one distributed among the minority interests at its fair cost on the date of the purchase.

The method of the acquired goodwill is sometimes connected with the same difficulties in measuring as the method of full goodwill. For instance, similar difficulties in measuring arise in the following circumstances:

♦ amalgamation is conducted through the share-to-share exchange between the two companies owned by independent parties:

♦ amalgamation when two companies owned by both sides unite the membership profit without any other payment type;

♦ amalgamation when the control over the invested company is achieved without purchasing an additional share of property (when, for example, the invested company buys several or all securities and other property tools from the outside shareholders).

Analogous difficulties with measuring were also noticed when testing goodwill for devaluation. The devaluation test is based on measuring the refundable unit cost the goodwill refers to, generating the monetary means. If it appears burdensome to measure the fair cost of the net wealth purchased in the course of the current deal, it will be hard to prove the adoption of the approach "only devaluation" of the goodwill after the original acknowledgment resting on the fact that the refundable unit cost generating the monetary means must be calculated under the conditions of absence of any evidence based on the real deals.

In addition to the information mentioned above the participants of "field" tests CIAS phase 1 of the project "Business amalgamation" were questioned on the presence of any difficulties in application of the Statute on the USA Financial Accounting Standard (SFAS) 142 "Goodwill and other intangible assets", in measuring the fair cost of accounting units the goodwill refers to. The participants of the tests from the USA and Canada noted that the estimation of the fair cost of accounting units sometimes comes across as a complex process even though the ultimate step, the estimation at the fair cost may be testified when required.

Full fair cost of the purchased net wealth (as a material complex) can be measured by two approaches. The first includes an immediate estimation of the fair cost of the purchased net wealth with the help, for example, of an invited estimator or another estimation technique. The second approach implies the estimation of full fair cost of the purchased net wealth on the basis of the reward paid by the purchasing company for the controlled share of the property of the company being purchased.

There are some ways of estimating the full fair cost of the purchased net wealth on the basis of the reward paid by the purchasing company for the controlled share of the property. There are some ways of defining the fair cost:

♦ by the reduction from down upwards resting on the reward paid for the controlled share of the property;

♦ by the addition to the reward, paid for the controlled share of the property, the fair cost of the rest uncontrolled share of property, if that cost can be taken out of the costs of shares, not auctioned in public.

The definition of full fair cost of the purchased net wealth through the reduction resting on the reward paid for less than 100 % share of property puts forward the questions about the reliability of the ultimate estimation. This happens due to the fact that the reward, paid by the purchasing company, may partially include a premium, paid for acquiring the control over the company being purchased. That premium should not be distributed on the share of the minority. So the reduction of the full fair cost of the purchased net wealth resting on the reward, paid for the controlled share of the property, can be unsuitable when there is an evidence for the supposition that the premium for the control exists and cannot be measured separately.

There are, however, some circumstances in which the sum of the premium for the control, paid by the purchasing company, can be reliably determined, and so that the full fair cost of the purchased net wealth can be estimated through the reduction from the reward, paid for the controlled packet of property shares without any problems of distributing the premium for the control over a share. That happens when, for example, the purchasing company buys a packet of shares (e.g. 51 %) from the parent company (51 % of property of the company being purchased) as a result of one deal, and the price paid exceeds the price, available from the public trading sources where the "minority" shares of the company being purchased are actively auctioned. The reduction of full fair cost of the purchased net wealth from the paid reward is also possible when the purchased share of property is substantial enough.

As a result, the Board IAS resolved that when the purchasing company buys less than 100 % of property share of the company being purchased can be conducted through reduction of full fair cost of the purchased net wealth resting on the reward paid, provided the premium, paid by the purchasing company for the control can be determined and estimated reliably enough. If the premium for the control (in case, there is one), paid by the purchasing company, can not be estimated reliably enough, the full fair cost of the purchased net wealth should be measured with the help of some estimation technique. In such cases the aim of the estimation technique is to estimate the fair cost of the reward, the participants of the market must pay for buying 100 % share of property of the company being purchased.

The Board IAS did not accept the argument on the absence of the reward paid for the company as a whole, as well as the other information or estimation technique available for determining the full fair cost of the purchased net wealth. In the world practice, there are known several estimation techniques. The use of several estimation techniques guarantees the reliability in measuring the ultimate fair cost.

IAS 3 requires the buyer to register the contingent liabilities of the company being purchased separately on the date of the purchase as a part of amalgamation cost in case when the fair cost of contingent liabilities can be estimated reliably enough.

IAS 3 requires the original estimation by the buyer of all the identifiable assets, liabilities and contingent liabilities of the company being purchased at the fair cost on the date of the purchase.

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