

# Goodwill

- **arises due to a difference between**
  - cost of acquisition and
  - book value of assets acquired
- **treatment: write off to reserves**

## Balance sheet at 20X1

### Assets

Bank -100

Investment +80

### Liabilities

Reserves -20

P&L

- **comments**
  - the expenditure never gets charged to P&L
  - shareholders funds are reduced
  - increases gearing ratios (debt to shareholders' equity)
  - bringing companies closer to their bank covenants
  - previous UK practice, but now outlawed

- **treat as asset**

Balance sheet at 20X1

Assets

Bank -100

Investment +80

Goodwill +20

Liabilities

Reserves

P&L

- **Comment**

- not necessarily an asset, but an overpayment
  - inconsistent with statement of principles as
    - asset gives "rights or access to future economic benefits"
    - some companies tried to justify the asset as a brand value
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- **FRS10**

- treats as asset
- rebuttable presumption that useful life does not exceed 20 years

- **US and Canada**

- 40 years is maximum, and many companies use that period

- **International pressure (especially US) for impairment review only**

# Negative goodwill

- **Price paid less than the asset value**
  - (1) bargain purchase
  - (2) price adjusted to reflect future losses.  
Here asset values are probably too high
- **FRS10, Goodwill and other intangibles**
  - negative goodwill included as a negative asset, not a liability
  - amortised back to P&L to increase profits
  - however, in (2) above, FRS10 requires impairment test, as it looks as if assets are overvalued
  - negative goodwill arises only in (1)
- **IAS22 Business combinations**
  - a negative asset, as FRS10
  - cannot now use to reduce the values of other assets
  - may also arise from expected future losses (unlike FRS10)
    - write back to P&L as losses incurred

- **Monetary and non monetary assets**

**Balance sheet at 20X1**

<b><u>Assets</u></b>	<b>(a)</b>	<b>(b)</b>
<b>Bank</b>	<b>-80</b>	<b>-80</b>
<b>Acquired current assets</b>	<b>+10</b>	<b>+90</b>
<b>Acquired fixed assets</b>	<b>+90</b>	<b>+10</b>
<b>Negative goodwill</b>	<b>-20</b>	<b>-20</b>

- **purchased assets of 100 for 80 = 20 gain**
- **case (a)**
- **all the "free" assets are assumed to relate to the fixed assets**
  - gains written back to P&L as asset depreciated, in both FRS10 and IAS22
- **case (b)**
- **10 of the free assets *must* relate to current assets acquired**
  - IAS22, these gains written to P&L immediately
  - FRS10, recognised "in the periods expected to be benefited" (rather vague, but probably the same as IAS22)

- **But does amortisation really matter?**
- **Moehrle, Moehrle & Wallace, How informative are earnings that exclude goodwill amortisation?, Accounting Horizons, Sept 2001**
- **examines the correlation with stock returns, 1988-98**
- **Measures of earnings**
  - IB net income, after taxes, before extraordinary items
  - CFO cash flow from operations
  - IBAI as IB but excluding amortisation of intangibles
- **Company returns measured over 12 month window ending 3 months after year end**
- **Excess returns obtained by deducting market returns (over the same period) from company returns**

- Model estimated is
- Excess returns =  $a + b_1X_t + b_2X_{t-1}$
- where  $X_t$  is a measure of performance (IB,CFO, IBAI)
- in addition, they allow for different coefficients for positive and negative  $X_t$  and  $X_{t-1}$ 
  - losses are more temporary than profits
- results where amortisation is  $> 0$

	Coefficient for IB	Coefficient for IBAI	Coefficient for CFO
$X_t > 0$	3.97	3.5	0.58
$X_t < 0$	-	-	-
$X_{t-1} > 0$	-2.15	-1.97	-
$X_{t-1} < 0$	-0.41	-0.41	-0.41
$R^2$	0.13	0.12	0.02

- 2421 obs
- no difference between IB & IBAI
- CFO poorer

- results where amortisation is > 10%

	<b>Coefficient for IB</b>	<b>Coefficient for IBAI</b>	<b>Coefficient for CFO</b>
<b><math>X_t &gt; 0</math></b>	<b>3.65</b>	<b>2.9</b>	<b>0.38</b>
<b><math>X_t &lt; 0</math></b>	<b>-</b>	<b>-</b>	<b>-</b>
<b><math>X_{t-1} &gt; 0</math></b>	<b>-1.85</b>	<b>-1.60</b>	<b>-</b>
<b><math>X_{t-1} &lt; 0</math></b>	<b>-0.50</b>	<b>-0.51</b>	<b>-0.46</b>
<b><math>R^2</math></b>	<b>0.12</b>	<b>0.11</b>	<b>0.02</b>

- 1184 obs
- no difference between IB & IBAI
- CFO poorer

- **This supports US position of no amortisation, but review for impairment**
- **why?**
- **no discussion of this in the paper**
- **likely to be a material item (ie important)**
- **market regards the item as temporary**
  - that is, not part of permanent earnings?
- **market misunderstands, believing that amortisation is simply a book entry**
  - other evidence suggests that market misunderstands the mean reverting nature of accruals (Sloan, Accounting Review, July, 1996)
- **market is too optimistic about the decay in goodwill, part of analysts' optimism**
- **prediction of future cash flows would be a better test (eg, as Barth, Cram & Nelson, Accounting Review, Jan 2001)**