

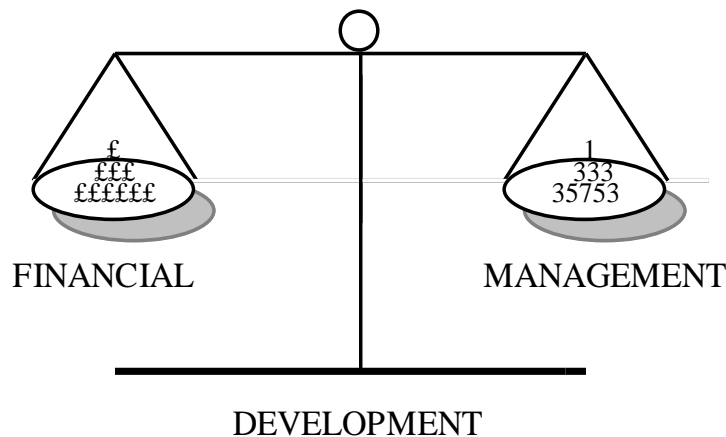
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Acquisitions

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ACCOUNTING FOR GOODWILL



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

ACCOUNTING FOR GOODWILL

OVERVIEW

A separate paper deals with the ground rules for consolidating the results of subsidiary companies into the Group Accounts. This paper examines a key problem facing preparers and users of Group Accounts:

With apologies to numerous tourist shops:

“Lovely to look at
Difficult to hold
Other assets you pay for
Goodwill is just sold”

GOODWILL

Goodwill can be defined as the excess of the purchase price over the fair value of the assets acquired. For accountants that suffices. However, in the real world goodwill is seen as the value of all the indefinable items that differentiate a company from a collection of assets. It is the “spark of life” which has value when a Company is in existence but disappears when the company dies and its assets are sold off piecemeal. Thus the goodwill which attaches to a company encompasses its customers and the likelihood they will continue to buy; its suppliers and the benefits to be gained from the company’s trading record with them; and last but not least its employees and the likelihood they will come to work on Monday morning. It also includes the value of brands, trade marks, trade names, patents, processes etc. which the business owns.

The very real problem for the accountant is that most of the above have not been explicitly paid for. Like Topsy they just grew. It is thus rarely possible to include them in the Balance Sheet because the Balance Sheet is merely a list of assets paid for but not yet used. To place a value on the various items and include them in the Balance Sheet is effectively recognising not their cost but their future value to the business. The recognition of future profits is an anathema to accountants as it goes against one of the fundamental accounting concepts - it is not prudent.

Many companies are therefore left with the situation that their published Balance Sheet leaves out the value of their most important asset - namely the value of their people. In normal circumstances this does not matter. Management are free to use or abuse people in the business - adding or detracting from Goodwill and making what appears to be an adequate return on the capital as disclosed in the Balance Sheet. Since the Balance Sheet is not a tool for running the business, management can ignore its deficiencies.

The problem arises when someone else wants to buy the company as a going concern. Assume that Company A bought 100% of B for £200, that B's assets consist of £50 of fixed assets and £50 of net current assets i.e. a total of £100.

The existing shareholders of B have considered the value of their shares in B and come to the conclusion that they are worth £200. In reaching this conclusion they have effectively valued goodwill. Their value of the amount they wish to receive to compensate them for losing their right to participate in the future profits of B is £100. That is the difference between the assets that are in the Balance Sheet and the total price for the shares. For the purposes of this paper we will assume that the values in the Balance Sheet are a reasonable approximation of the fair values of the assets. This may often be a rash assumption in real life.

Let us assume that the Directors of A are not put off by this price and they proceed with the purchase which now consists of a payment of £200 for assets worth £100. The apparent overpayment being an open market (willing seller and willing buyer) value of the goodwill of B. In accordance with good accounting principles above A Limited will pay £200 for the shares in B. In its own accounts it will show a decrease in net assets of the amount of the payments and a corresponding increase of £200 in cost of investment.

In the Group accounts the assets of B are shown as being part of the assets under the Group's control. However, on the acquisition of B, A paid £200 yet B's assets amount to only £100. No problem arises for the non-accountant. The Group has bought an asset called goodwill for a price of £100 so it should be shown on the Balance Sheet. The accountant does have a problem. The £100 paid for goodwill represents future profits that will be made. It is an intangible asset. It cannot be counted or verified. No value is recorded in A's books for the goodwill of A so how can the Group shown the goodwill of B? Anyway the profit might not be made!

Prudence one of the fundamental concepts of accounting dictates that future profits should not be recognised. Following this somewhat histrionic logic combined with historical cost logic; the accountant concludes that it does not exist. To paraphrase W.S. Gilbert "and if it does not exist, why not say so?" The accountant therefore does not show the Balance Sheet in Figure 1 but prudently writes off the goodwill as being valueless by reducing shareholders funds as if a loss has been made giving the Balance Sheet as in Figure 1a.

Figure 1**The Non-Accountant's Balance Sheet**A Group

	£
Goodwill	100
Fixed Assets	150
Net Current Assets	50
	——
	300
	====
Shareholders Funds	300
	====

Figure 1a**The Accountant's Balance Sheet**A Group

	£
Fixed Assets	150
Net Current Assets	50
	——
	200
	====
Shareholders Funds	200
	====

It is at this point that the non-financial managers who have followed this paper may say "That is daft". There are schools of thought that would agree with them. In America companies retain the goodwill as an asset in their balance sheets. However, like any other asset it is treated as having a finite life. As such the cost of goodwill acquired has to be written off over its life just as fixed assets are depreciated. After much consideration the American Accountants decided that the maximum life of this purchased goodwill is 40 years. Thus profits of American companies may show a write off of 2.5% p.a. of any amounts paid out for goodwill. In Europe a similar view prevails but the maximum useful life of goodwill is deemed to be considerably shorter - 5 or 7 years... Again the profits of companies reporting under this method will suffer from the writing off of the purchased goodwill.

At this stage it is reasonable to resurrect the reader's faith in UK accountants. The problem outlined above is covered in FRS 10 issued in December 1997, which recommends capitalising purchased Goodwill and writing it off over not more than 20 years. It does not allow capitalisation of internally generated goodwill. The position remains a difficult one as companies have been known to sell themselves purely to enable the internally generated goodwill to be recognised. Companies now show goodwill on acquisition as an asset.

The previous policy of writing off goodwill in the Balance sheet on acquisition avoided any charge against profits which would reduce the profit figure reported in the profit and loss account - nor would there ever be a charge against profits. The write off is made directly against reserves i.e. it is deducted from the total of retained profits in the Balance Sheet but does not go through the Profit and Loss Account. Even more creative is the thought that return on capital - a key yardstick of business success is based on profit divided by the total of shareholders funds in the Balance Sheet. By writing off goodwill the shareholders funds figure is reduced. Thus return on capital was much healthier!

The non-financial manager should not despair at this point. The published Balance Sheet is a statement of the cost of assets and not a statement of value. It is true to say the Non Accountant's Balance Sheet is not a reflection of the worth of the Group because it does not show internally generated goodwill either. In addition all the assets are at cost less any depreciation so they may have values which are significantly different from the Balance Sheet figures. The Balance Sheet and the Profit and Loss Account in a set of published accounts are designed as a record of past events. The Balance Sheet is a record of costs. It tells the shareholder where the money has been spent. It is not designed as statement of value nor is it designed to assist future decisions. The dilemma currently facing preparers of published accounts is that "not a lot of people knew that"...until now.

In FRS 11 (1998) the rules regarding reviews for impairment of purchased goodwill and other intangible assets are set out. The situation is fairly complex and fraught with possibilities for creativity. In many cases the discovery of unfunded pension liabilities in the early 21st Century (caused by a failure of actuaries to talk to accountants and vice versa, and a failure of either to talk to the Human Resources professionals in the previous Century) and the need to value those, swamped the difficulties of evaluating the exact value of Goodwill and attention was diverted elsewhere. For the lay user of accounts, it is probably enough to know that the values of Intangibles, such as Goodwill as shown in the Balance Sheet, whilst they may have had much time and money spent on their calculation, may or may not turn out to be different when circumstances change. However, since that is probably true of all assets (and many liabilities).

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:

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In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).