Is Goodwill and Asset or Not?

Table of Contents

Introduction:

For more than two centuries, legislators have been trying to give an acceptable definition of business goodwill. (Wood, 2011). Goodwill is the worth of a brand name, which is generated by years of hard work acknowledged by customers in the shape of trust they repose in the brand name in the shape of repeated orders or transactions with the business. Goodwill can either be generated by a continuous effort or be acquired along with a business. Accounting bodies have prescribed methodologies to account for goodwill in business transactions and reporting, but the problem is that those methods don't stand for every business as the business dynamics vary with multiple things such as nature of business, region, products, market and regulations.

We shall be discussing the following in relation to Goodwill:

1. Is Goodwill an Asset or not?
2. If it is an asset, does its value diminish over time (Amortization)?
3. How should it be accounted for?

Different sources shall be discussed and an effort shall be made to form an opinion on how to record Goodwill.

Is Goodwill an Asset or not?

Branding has emerged as a top management priority in the last decade due to the growing realization that brands are one of the most valuable intangible assets that firms have. (Keller & Lehmann, 2006)

An asset can be defined as a valuable property in the possession of its owner, having an economic value which the owner can use to generate positive economic value. Different believes exist as to recognition of Goodwill as an asset or not. (Petrone, 1999).

Asset can be a tangible asset or an intangible. Goodwill can be classified as an intangible asset as the brand name belongs to the owner and it generates positive economic value. This brand name can either be self-generated or be acquired in a business transaction (no matter if registered or not). The future of consumer marketing belongs to the companies with the strongest brands. (S. Cem Bahadir, 2008).

Here one thing is important in business reality, that Goodwill may not always be associated merely with a brand name but also with the people who work under the brand. Attaining and defending the rights to an intangible property has been a problem, and its benefits cannot be separated from the people creating and operating it. (Wyatt, 2005).

Accordingly, brand has more value if operated by its creator and less for a person who acquires it as the customers would know the change of management and would become more reactive to a change in product or service quality. However, the acquirer may operate business activities in a better way and satisfy consumers more than its originator, in which case Goodwill can become more valuable than it was for its originator.

How is Goodwill different from other intangible assets?

Intangible assets differ across businesses from brand names (Coca Cola) to patents (Pfizer) to technological experts (Microsoft), however they do have some common features. (Damodaran, 2007).

Goodwill is a diverse category of intangible assets which is hard to construe individually or measured directly. Goodwill cannot stand independently out of business. Other intangible assets like software, quotas and license are separately indefinable and can stand out independently out of business. A software for example has a brand name as well as its set of qualities like word processing, email processing or file conversions. It operates on a pre-defined systematic set of commands and without human error thing. A food chain brand on the other hand depends on quality of its staff and its brand name is linked to the performance of its humans.

If Goodwill is an asset, how should it be valued?

There are different approaches to valuation of intangible assets. A common method used is the present value of expected future cash flows. A corporate critique of valuation methods by financial analysts, in particular, is that we pay very little consideration to intangible assets and accordingly under value them. (Damodaran, 2007).

Valuation method could vary for each business, region, regulation and market. For Goodwill, a practical approach could be to assess the value of brand by changing the product characteristic or by introduction of a different product.

A cold drinks brand with cola drinks can introduce a lemon drink product or diversify into selling of chips under same brand name and check the customer response. A pizza master selling peperoni pizza can offer a fajita pizza, or diversify into selling burgers and shawarmas and evaluate the customer response. Similarly, a reputed Chinese food restaurant offering noodles only, can extend their continental menu or can offer Asian foods additionally, and the customers are likely to trust them due to their brand name for quality.

Same approach can be used for other intangibles. Microsoft started with windows, and subsequently offered different products like Antivirus, Office, Media Player and they got accepted as it was Microsoft.

If it is an asset, does its value diminish over time (Amortization)?

Everything loses its value over time, so does every intangible. Apparently software does not lose value on its own, but indeed the value is lost in a way that customers switch to other software or the need for software no longer exists. Goodwill also loses value over time in the form of customer switching.

The question here is; how can the diminishing value be measured. We take the 5% edge as goodwill is prone to periodic amortization, in this period we seek to eradicate small reductions in goodwill that could reflect amortization. (Kevin K. Li, 2017).

Different approaches exist e.g. 10 years for software and award period for a license. For an intangible awarded for a certain period of time, amortization can be measured accurately (over the period of award). However, for things like software or Goodwill, it depends upon multiple factors and a fixed percentage would not always be the best way.

Also there is a fact that Goodwill would not always lose its value, instead the value would increase over time. Analysts usually add back amortization expense, seen as random, discreetly rejecting accountants' attempts to deal with intangible appraisal in this way. (Penman, 2011).

Satisfied customers play an important role in increasing Goodwill by speaking about how good a product is, posting reviews over social media platforms etc. Furthermore, many have directed that the impairment-only methodology could have played key role in the financial crisis. That is impairment losses would often come too late, since the current approach does not allow the illustration of yearly consumption of attained Goodwill. This outcome has been made apparent in recent years, in which many bodies recognized impairment losses of goodwill year after the financial crisis, when financial marketplaces, possibly, had already taken them into account. (EFRAG, 2014).

Amortization should be calculated carefully. The present accounting requirement is that recorded goodwill should be spread over a maximum of forty years, but this has repeatedly been carped by financial statement experts and financial analysts. They insist that goodwill amortization is less likely to be representative of the current or future performance. Therefore, it reduces the usefulness of accounting earnings as a basis for valuing shares. (Ross Jennings, 2000).

There exists an opinion that Goodwill need not to be amortized, however this does not fit in business environments as Goodwill balances could pile up to a significant amount not representative of real business value. Periodic amortization could be a good approach as it prevents Goodwill balances from growing too large.

Best policy however is to engage experts to perform impairment testing for Goodwill so as to reflect the realistic business value (Fair Value). The fair value model is arguably well structured but is prone to devious managerial behavior. Managers are assumed to be reluctant to charge impairment to goodwill, as it is could be interpreted as a fact that they paid excess for the related business acquisition. The subjective fauna of goodwill impairments also makes it hard for auditors and legislators in enforcing impairments. Resultantly, it appears that the systematic amortization of goodwill along with a periodic test for impairment can lead to improved accounting treatment, that better reflects the essential economics of goodwill. (Kevin K. Li, 2017).

How Goodwill should be accounted for?

So far we have reviewed and analyzed different approaches to Goodwill recording and impairment, now we shall form a personal opinion on treatment of Goodwill.

If a business is purchased and amount paid exceeds the business value of assets, it means we paid excess for the business Goodwill. In this case, Goodwill should be recorded on the differential amount.

If the business we are about to purchase has acquired the brand name externally, Goodwill would have a definite amount recorded in the books of business. This value, after a careful review of impairment, can be used to record in the books of newly acquired business.

For a freshly established business, it can be real hard to assess the value of Goodwill. A lot of factors decide the value of Goodwill, but the prime factor is value of product. Following should be considered for product valuation:

1. The product we are going to sell, is it expected to follow an increasing trend in sales or sales would decline over time? Appropriate market research needs to be done. By studying similar products, doing surveys and taking feedback from initial customers would help in this study.

2. Are there any environmental changes expected to effect the product sales? Hot beverages are less likely to perform well in summer, and cold drinks in winter. Appropriate marketing strategies help in keeping the sales above break-even in such circumstances. Also products could be re-engineered to meet needs of changing environments.
3. Are there any regulatory factors which could affect product sales? Governments are restricting sale of energy drink near secondary schools due to health concerns. Youth is the primary target market of such drinks, and schools are the keys markets areas. With this restriction, sales could decline significantly.
4. Market competition is a key factor in determination of Goodwill. No matter what we sell, competitors would arise. Even for the registered patent, alternates would be prepared and competition would start. In such a dynamic business environment, prices would need to be competitive and extensive marketing strategies would become inevitable.
5. Human nature is such as it would use a product for some time, and no matter the consistent utility, a need to try different product would arise. Law of marginal utility applies here, everything loses its utility with repeated use. This factor is often neglected is product valuation and ultimately Goodwill valuation.

Once the product value is decided, Goodwill value can be ascertained easily. If a product becomes successful under a brand name, and a different product under same brand name also gets accepted immediately, this would indicate that Goodwill has been established with the value of product sales expected in future.

Once recorded, it should be periodically re-assessed for impairment. It can lose its value over time or a positive trend could also be observed. If the business keeps on performing well, it means the Goodwill is growing and a positive revaluation is appropriate. However, a systematic approach should be used to not overvalue or undervalue Goodwill.

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