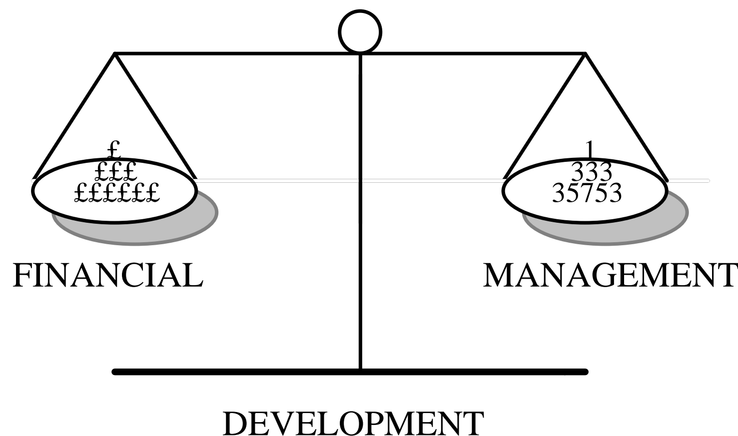
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Acquisitions

NO 153

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 then; 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 growed. 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.

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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.

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<u>Figure 1</u>

<u>The Non-Accountant's Balance Sheet</u>

<u>A Group</u>

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

<u>Figure 1a</u>

<u>The Accountant's Balance Sheet</u>

<u>A Group</u>

	£
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.

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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.

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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.

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 thirty major organisations including Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, The Post Office, Rothmans and Zeneca. International training experience includes work in Denmark, Kenya and the Czech Republic for Unilever, in Dubai for Al Atheer, in Holland and the U.S. for Avecia and Zeneca and in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. A key output from the training is demonstrable use of the knowledge and skills acquired to enhance corporate profitability. In addition he has run courses in acquisition evaluation (The Economist, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). He has also developed material for delivery by in house personnel (Royal Mail, Lloyds Bowmaker and Conoco) and computer based training packages (The Post Office, Unilever and BP).

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 and the need for taxation awareness training for general managers.

He is married with one grown up daughter and his outside interests include being The Treasurer of the Hospice of St. Francis (Berkhamsted), and a member of the Catholic Alpha Training Team (Promoting the Alpha course on Basic Christianity). He was a Governor of Luton University for nine years and a school Governor for four years.

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).

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