

Goodwill – the recognition and measurements according to the European accounting legislation and the international financial reporting standards

Goodwill – vymezení a způsob výpočtu goodwillu dle vybraných evropských právních úprav a mezinárodních účetních standardů

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Abstract: The paper is concerned with the comparison of the approaches of the chosen European accounting legislation to the initial recognition and measurements after the recognition in case of goodwill and badwill (respectively acquisition differences) with approaches used by the IAS/IFRS. There are compared strengths and weaknesses of the individual approaches. The main problems are defined and solved. The paper is also concerned with the date significant for the acquisition and goodwill calculation.

Key words: acquisition, intangible fixed assets, goodwill, badwill, appraisalment, fair value

Abstrakt: Příspěvek se zabývá komparační analýzou přístupů používaných ve vybraných národních evropských účetních legislativách k výpočtu a následnému nakládání s goodwillem (resp. kladným či záporným akvizičním rozdílem) s přístupy k tomuto fenoménu uplatňovanými v rámci mezinárodních účetních standardů. Jsou uvedeny některé přednosti a slabiny používaných postupů. Rovněž jsou definovány hlavní problémové oblasti, které mají nepochybně vliv na hodnotu goodwillu. Z nich je pak hlavní pozornost věnována otázce stanovení data rozhodného pro vyčíslení goodwillu a jeho dopadu na stanovení výše uvedené položky.

Klíčová slova: akvizice, nehmotný majetek, goodwill, akviziční rozdíl, oceňování, fair value

Goodwill represents a significant economic phenomenon. This interesting value first appeared at the end of the 19th century in the legal field and later also in the fields of economics and accounting. At that time, it was common that goodwill was perceived as an item providing the company with the ability to create a higher profit (i.e. oversized earnings capacity, over-profit, capitalized value of future estimated profits) as compared to another or average company in the same branch. The item was always perceived as something intangible, technically useless, related to the accounting unit, something you cannot sell or transfer – **therefore inseparable**

from the accounting unit – **and something that could** have a distinctly fluctuating value. Intangible assets and goodwill in particular represent items whose value is very difficult to evaluate for the accounting purposes and expert opinions of this issue are often opposing. Many approaches used in national accounting legislations as well as the present and past approaches of international accounting standards and other submitted and discussed proposals no doubt have their positives but also drawbacks from various points of view. It is quite difficult to find an accounting solution of goodwill that would be generally accepted all over the world.

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The objective of the contribution is to present the results of an analysis in the field of the development of the selected approaches to goodwill concerning the opinion on its core, its depiction in financial reporting and its subsequent handling within accounting in the selected European systems. An individual objective is to define the main issues that need to be addressed in order to reach at least an approximate spatial comparison of financial reports in this field. As it is a very wide and complicated issue, the given enumeration cannot be considered complete and comprehensive. Some of the presented issues are demonstrated in a greater detail on the actual data, mainly concerning the issue of determining the appropriate moment for the calculation of goodwill during the gradual acquisition of shares.

MATERIAL AND METHODS

In order to achieve the set objective, we had to analyze the legal regulations of the selected European countries in the field of intangible assets and acquisitions. These legal regulations, especially in the area of goodwill, were compared with concepts (past and present) of the international accounting standards, particularly the IAS/IFRS, and approaches of the selected accounting experts. On the basis of the analysis, major pros and cons of the presented approaches were stated regarding the first depiction of goodwill and in relation to the subsequent dealing with this item. Special attention was paid to the negative acquisition difference that by its content represents a completely different item to the positive difference. After that, we established the sphere of issues that need to be addressed in relation to the performed acquisitions so that the financial statements of reporting companies could be at least approximately comparable. An actual example of the gradually acquired share in another company shows that the final evaluation of this intangible item can be done in a completely different way in relation to the differently determined moment of accounting individual items of goodwill, which can naturally affect the decisions of the users of the company financial statements.

RESULTS AND DISCUSSION

There were differences in the theoretical and practical opinions on how and whether at all to report goodwill in financial statements of the reporting companies as early as the 19th century. The effort to

report a good name of a company in the accounts and to distinguish a company with good reputation from others in accounting was a positive aspect. However, the main argument against the capitalization of this item in the balance was the issue with its valuation. It is very difficult to reliably evaluate properties such as management quality, customer perception, qualification and loyalty of employees, monopoly position on the market, etc. Another substantial issue discussed was the matter of transferability of this item upon death of the company owner. Another controversial issue is whether accounting may take the *estimated* future earnings into consideration at all – **statements** of financial accounting should show the results of past transactions and not future expectations that may change substantially with the changing external conditions – **or the common** ability of assets to bring profit. The procedure of defining the usual profitability of a comparable company is also considerably subjective. The US crisis in the 1930s promoted the growing opinion that presenting primary goodwill within assets is not suitable as, apart from other things, its value depends on a substantially subjective evaluation of the evaluator and there was a tendency to include goodwill into the costs of the given period. Since 1930s, there has been an opinion (e.g. Canning 1978) that goodwill has to be approached as a *recalculation quantity*. This item helps to report positive values of assets that could not be classified as “**net**” **assets of the company**. **This concept logically** excludes the option to report goodwill as a negative item and the occurrence of such a case is allowed only when the seller acted in distress or when there is insufficient information etc.

The analysis of the available literature allows a basic division of goodwill into two items:

- **Secondary goodwill** = goodwill that:
 - was included in the acquired unit during a company combination or
 - was created by the synergic effect as a result of a company combination
- **Primary goodwill** (does not meet the conditions for secondary goodwill) – **it is mainly an internally created goodwill**

However, primary goodwill may be also perceived in the following way according to e.g. Zelenka (2006):

- **As goodwill created by the company** (management quality, qualification and loyalty of employees, results of advertising and public relations, established customer network, perception of the company by customers, lending subjects, administrative bodies, quality information system (formal and informal) and other. Tomšík et al. (2009) deal with factors af-

fecting the methods of the employees management in agribusiness companies in the chosen region,
– **And as goodwill created without the effort of the accounting unit as a result of favourable external circumstances – i.e. favourable natural, legislative, demographic or other conditions.** This part of goodwill was not usually reported in the accounts of any accounting system.

Secondary goodwill is created with acquisitions and it is usually related to the payment for the acquired company. There is quite a great conformity within the various accounting systems that it is not convenient to report primary goodwill in the assets, at least not until it is transformed into secondary goodwill within the company combination.

Expert opinions on treating goodwill are miscellaneous: from the opinion that it is appropriate to try to report both primary goodwill (including goodwill from favourable external circumstances) and secondary goodwill into financial statements (e.g. Arnold believes this – **according to Wolk (2007) up to another extreme opinion that no goodwill should be reported in the statements mainly due to the problems with evaluating this item (promoted by e.g. Schuetze 2007).** Opponents to goodwill capitalization also argue against its reporting in the financial statement as it causes asymmetry. If the accounting unit does not report primary goodwill in the assets, then it is illogical and unsymmetrical to balance secondary goodwill which indisputably includes a part of primary goodwill after the acquisition. However, *most* accounting systems apply a compromise approach when only secondary goodwill created in relation to acquisitions is balanced.

The basic question is whether goodwill conforms to the definition of an asset. If the correct and unambiguous definition of the asset is the definition by the IAS/IFRS (concept framework) and US GAAP (SFAC 6), then the following criteria must be met simultaneously:

- (1) An asset must bring future economic benefit, contribute to future inflow of money
- (2) A company can control this benefit and can prevent other persons from accessing this benefit
- (3) The economic benefit is a result of past events; the transaction or another fact has already taken place.

The first condition is fulfilled with respect to the fact that the future benefit is not provided by goodwill itself but in combination with other assets. As for the second condition, it is undisputable that the control over assets together with goodwill by

the acquiring accounting unit is certain only when a majority share in the control is obtained. This criterion is not usually met if only a substantial effect on the control is reached. Moreover, there is another strong argument in this field by the opponents to accounting goodwill that goodwill cannot be *independently* disposed of, therefore, the control is only possible in connection with other assets. For instance, Schuetze (2007) emphasizes that this item cannot be traded, used as a settlement of a liability, distributed among owners, etc. Archer in Wolk (2007) holds a similar position when he states that it is only a corrective item that **“occurs during aggregation and disappears during disaggregation”** and there is no reason to depict this unreliable item in the assets. However, supporters of the goodwill capitalization state that the control of assets as a whole is sufficient for the definition of assets. The third condition is almost always met.

We have analyzed legal regulations in the field of goodwill of many European countries on which we managed to obtain the up-to-date data and the way of reporting goodwill was compared in accordance with international accounting standards. The analysis implies that in most cases, according to national legal regulations goodwill is calculated as *a recalculation quantity between the amount paid within the acquisition and the sum of net values of the assets (in market or book value) decreased by the potential liabilities assumed.* However, there are differences in the approach to negative goodwill, the method of evaluating the individual items and dealing with goodwill after the acquisition. The approaches of the inspected national legislations are presented in the Table 1. The mentioned approach virtually never takes into account the value of some items that do not have to be reported in the balance of the acquired company pursuant to accounting regulations.

The calculation of goodwill and its subsequent manipulation depends on the method of acquisition within some accounting systems or systems of financial reporting. The most common methods of acquisition are:

- **Purchase of a company or its part – this method is sometimes called *property acquisition***
- **Investment of the company or its part – sometimes called *regressive capital acquisition***
- **Purchase of a share (business share, securities) in a subsidiary – sometimes called *capital acquisition***
- **Other methods of acquisition (such as the acquisition of a substantial or controlling influence without the effort of the accounting unit e.g. as a result of the decrease in the registered capital by annulled owned shares etc).**

Each presented solution has its advantages and disadvantages. The main positive aspect of the single incorporation of the acquisition cost surplus into the costs of the period (applied e.g. in Switzerland) is that this uncertain item does not burden accounting

statements. On the other hand, this approach is not used very often in national legislations and in the international accounting standards it is usually used for settlement of a negative item (negative acquisition difference). The advantage of the approach which

Table 1. Approaches to dealing with goodwill created by acquisitions in the selected European regulations

State	Reporting active goodwill	Reporting passive goodwill (badwill)	Subsequent dealing with goodwill	Note
Belgium	Obligatory	Not possible	Gradual depreciation into costs	
Estonia	Obligatory	Not possible. The value of individual assets is decreased by the value of negative goodwill	Gradual depreciation of the asset against the capital	
France	Possible	Possible	Gradual depreciation of value is necessary, however, regular depreciation is not required	
Ireland	Yes	Not possible	Depreciation is not necessary, may be considered an item with unlimited usefulness	
Italy	Obligatory	Not possible	Gradual depreciation	
Hungary	Obligatory	Not possible	Gradual depreciation	
Germany	Possibility of choice (in accounting)	Forbidden. Negative difference can be immediately included in revenues or individual assets may be decreased pro rata	Accounting depreciation of the active item into costs max 4 years since the result or decrease in the valuation of non-financial assets.	Tax obligation to report active goodwill and depreciate into taxation costs
Netherlands	Possible	Possible	Immediate depreciation against the capital or gradual depreciation of the active item into cost up to 10 years at most	
Poland	Yes	Yes	Depreciation into costs or revenues up to 5 years	
Austria	Obligatory	Not possible. The value of individual assets is decreased by the value of negative goodwill	Gradual depreciation against the capital	
Russia	Not created	Not created	The amount is calculated into market book values of the items	It is tolerable to re-evaluate assets, even not systematically
Spain	Yes	Yes	Gradual depreciation for the period of 5 years, if justifiable of 20 years at most	
Sweden	Yes	Yes	Gradual depreciation for the period of usually 10 years, max. 20 years	
Switzerland	Yes	No	Possible depreciation into costs or capital	
United Kingdom	Yes	No	Immediate depreciation against owned capital or gradual depreciation during the period of economic lifespan	

Source: Svoboda (2009)

includes a single burden of the owned capital in the year of the acquisition (used for e.g. in the United Kingdom or the Netherlands as one of the alternatives) is that the economic results is not burdened by this operation in the year of the acquisition and therefore this item will not have an effect on the judgement of the investor. The approach when goodwill is not created and the given amount increases or decreases the individual prices of assets acquired (e.g. Russia) also has its advantages (again, there is no burden on the statements by this uncertain item), on the other hand, the distribution of this amount into individual assets in the relation to their prices (fair value or book values of individual assets) is

hardly defensible. The given asset does not always bring exactly the same future benefit (corresponding with the price of assets); moreover, there is the effect of joint activity of assets. Generally, negatives of this approach predominate with the main argument against this solution being that increasing assets above the fair or historic value is against the basic methods of valuation in financial reporting. Overall, we can state that the predominant approach is that of reporting goodwill as an asset (sometimes even as a negative asset or a positive liability quantity) and its gradual depreciation during the period of estimated usefulness (which is always a considerably subjective estimate) or during the period determined by law

Table 2. IAS/IFRS approach to positive and negative acquisition difference

Standard – effective from	Calculation method	Negative item	Subsequent dealing
IAS 22 (1983)	<ol style="list-style-type: none"> 1) Goodwill is created as a difference between the acquisition costs and the fair value of net assets of the acquired unit 2) The alternative is not to report goodwill (there is depreciation in the debit of owned sources) 	<ol style="list-style-type: none"> 1) May arise. The item is depreciated gradually into revenues through the deferred income 2) The alternative is not to report goodwill but to decrease the fair value of the acquired assets pro rata 	Depreciation up to 5 years
IAS 22 (1993)	See the previous – moreover, the criteria for the recognition of assets are set precisely	See the previous – combination of decreasing assets with depreciation into revenues is also possible	Depreciation recommended for 5 years (max. 20 years). Depreciation into costs in some cases is also possible
IAS22 (1998)	Introduces two methods for depicting different transactions. Method of purchase – for cases when it is possible to determine the acquirer (goodwill is created) and method of share consolidation when it is not possible to determine the acquirer unambiguously (goodwill is not created). In comparison with the previous version it allows considering assets that are not in the balance of the acquired subject (mainly intangible), but not conditional assets and liabilities. It also solves step-by-step acquisitions.	<p>The negative item must be:</p> <ol style="list-style-type: none"> 1) Valuation of acquired assets must be revised first 2) The remaining negative goodwill may be gradually depreciated in the year of the acquisition into revenues in relation to the estimated costs of the stabilization of the acquired unit 3) The remaining assets may be depreciated according to the average lifespan of the acquired assets 4) If any value remains, it is considered to be the revenue in the year of the acquisition (revenue from advantageous purchase) 	The usual period for depreciation is 20 years, short-term unjustifiable depreciation is forbidden. It introduces factors that have to be taken into account during depreciation. It brings the obligation to test deterioration.
IFRS3 (2004)	Allows considering the conditional liabilities of the acquired company.	The negative item is not called goodwill but surplus of the acquisition costs. The item is included into the revenues of the period after the obligatory revision of the valuation of the assets and liabilities.	It does not allow systematic depreciation. Only testing for deterioration

Source: Svoboda (2009)

or other regulations. The often discussed approach that would divide goodwill into the part which has a relatively stable value and the part whose value gradually decreases virtually does not exist in the inspected legislations.

When we compare the approach of the European regulations to goodwill with the concept of the international accounting standards, it is possible to state that the following methods of accounting reporting of company combinations have evolved during the development of the national and international accounting systems:

- Method of purchase (purchase of a company or net assets)
- Method of acquisition (modified method of purchase)
- Method of share consolidation (only during the consolidation of two more or less equal partners – no goodwill is created during this method)
- Method of a new accounting unit (the existing subjects cease to exist and a brand new accounting unit is created)

The development of the IAS standards is presented in the Table 2.

A whole range of questions may arise during the analysis of company combinations in relation to goodwill:

- Should a different level of goodwill be created in relation to various methods of company combinations?
- Does it make sense to consider the size and character of the combined and combining subject? (SME, etc.)
- Which values should be measured against each other (purchase price of the company x net asset value, fair value of the acquired unit x fair value of identifiable assets etc),
- How to determine the fair value of individual assets? Is it appropriate to consider the fair value of the whole assessment and what is the best way to determine it?
- Should items that are not in the balance of the acquired company be considered during the calculation? If so, which ones? Is it also possible to balance items that are not an asset or liability from the point of view of the accounting theory?
- Should the method be different when associated or not associated sides are considered?
- Is it possible to balance negative items? Should goodwill be created even if the purchase price is negative (overextended company)? If it is appropriate to balance this item, is it a negative asset (correction of assets) or liability?

– It is possible to compensate items (positive and negative) of goodwill created by various transactions?

– How to deal with transaction costs of the acquisition?

What is the best way to determine the moment of the acquisition, particularly for gradual acquisition of shares?

– How to deal with goodwill after the acquisition? (Depreciation, testing for the loss of value etc).

– How to consider the decrease or increase in the percentage of influence in another company?

– In case of controlling influence, should the created goodwill be related proportionally to the influence on decision-making or should the control of assets be considered absolute (no shortening of goodwill proportionally to the influence)?

Quite an important issue is the matter of determination of the moment of the valuation of goodwill created by acquisition. The impacts of the decision may be demonstrated on an example of a gradual acquisition of a share in the company. The example considers a usual situation when the costs of the acquisition of one share necessary for reaching the controlling influence are higher than the costs of a minority share. In order to simplify the example, other costs related to the acquisition are not taken into account. The method of purchase is used. The following approaches to reporting goodwill can be found:

- (a) The overall goodwill is created by the sum of individual parts of goodwill during the individual purchase of shares as a difference between the acquisition price of the share and the net value of assets,
- (b) Goodwill is quantified as a difference between the overall price paid and the net value of assets determined as of the moment of obtaining the controlling influence,
- (c) Goodwill is determined to the balance date for simplification (other substantial data are described in the appendix to accounting statements).

Ad (a), one of the approaches to goodwill evaluation is the procedure when the fair value of individual assets during the purchase of each share is monitored and goodwill created by the purchase gradually increases as a sum of the individual items of goodwill. The advantage of this method is the overview of the gradually growing item as well as the commensurability of costs of the acquisition of the share and the share in net assets as of the given moment. On the other hand, this method disproportionately burdens the ac-

Table 3. Acquisition difference with the depiction of individual goodwill items at the moment of the payment

Acquisition date	Share in decision-making	Payment for the share	Paid in total	Assets	Liabilities	Total net assets	Share in net assets	Acquisition difference	Cumulative difference
I/200x	27	17 500	17 500	60 000	3 000	57 000	15 390 (27%)	2 110	2 110
I/200x+1	21	12 500	30 000	75 000	3 200	71 800	15 078 (21%)	-2 578	-468
I/200x+2	24	22 500	52 500	96 500	2 900	93 600	22 464 (24%)	36	-432

Source: Svoboda (2009)

Table 4. Acquisition difference with the depiction of goodwill at the moment of reaching the controlling influence (discounted and not-discounted payments)

Acquisition date	Payment for the share	Paid in total	Payments in the future value of the moment I/x+2	Cumulatively	Share in net assets	Acquisition difference without recalculation	Acquisition difference recalculated
I/200x	17 500	17 500	19 294	19 294			
I/200x+1	12 500	30 000	13 125	32 419			
I/200x+2	22 500	52 500	22 500	54 919	$0.72 \times 93\ 600 = 67\ 392$	-14 892	-12 473

Source: Svoboda (2009)

counting unit by the necessity to continuously value (re-evaluate) the individual assets. The Table 3 shows a calculation of goodwill according to this method (under the conditions of the share purchase stated in the first three columns of the table). The reached goodwill value is **-432 thousand monetary units**.

Ad (b) However, if you wanted to monitor goodwill from the moment of reaching the controlling influence (January 200x + 2), its value would be related to the net value of assets expressed as of the moment of reaching the controlling influence and it would naturally be different (in this case **-14 892 monetary units**), as shown in Table 4. This approach respects the fact that we actually do not control goodwill until the moment of reaching the controlling influence. On the other hand, the disadvantage of this method is that the sum of payments from various moments of acquisition and the share in net assets as of the date of reaching the controlling influence cannot be mutually measured in full. The method may be modified by the recalculation of payments for the future value as of the date of reaching the controlling influence. As stated in Table 4, the value of goodwill is **-14 892 monetary units without considering the influence of time and -15 353 when the payments**

are recalculated to the future value as of the date of reaching the controlling influence. The future value is calculated with the annual interest rate of 5%.

CONCLUSION

In the past decades, the success of a company in the market is more and more often conditioned by intangible assets such as the results of research and scientific activities, successful projects, etc., than by classic tangible assets. Goodwill holds a specific position among intangible assets. The opinions on which part of goodwill should be reported within assets, how to evaluate this item and how to deal with it vary and change as the accounting theory develops. Approaches applied within various European accounting systems as well as international accounting standards both past and present bring a whole range of positive aspects as well as individual drawbacks. However, the impact of the selected method on the level of the balance sum as well as the course of the economic result may reach substantial differences and therefore to influence the future decision-making of the users of the financial statement. This contribu-

tion demonstrates this impact on the question of the determination of the moment of the acquisition for the calculation of goodwill.

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