

Accounting for Goodwill: Benefits, and advantages of the good name, reputation and Connection of a Business on Horizon of Time for Innovation

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Abstract

1 – Objective: This paper is motivated by the controversy surrounding the regulation of accounting for goodwill and the limited evidence regarding the determinants of the discretionary accounting treatment of goodwill.

Firms faced a trade-off between their incentive to maximize the recognition of tangible assets to strengthen balance sheet ratios and their incentive to recognize goodwill to improve post acquisition profits.

2 – Methodology: Regression models to measure the proportion of purchase price allocated to goodwill that is negatively associated with the leverage of the acquiring company and the size of the acquisition, this explain the negative relation between the recognition of goodwill and leverage as being driven by the incentives of highly levered firms to opportunistically improve their balance sheet position. So management is able to maximize the assets available to secure future debt by recording a greater proportion of the purchase price as tangible assets. The explanation offered for finding that larger acquisitions are more likely to result in the recognition of lower goodwill balances is based on the premise that, the more material the acquisition is to the acquiring firm, the greater the exposure to the risk associated with the acquisition.

3 – This preliminary results: provides management with an incentive to recognize a greater proportion of tangible assets to provide greater assurance to shareholders of the availability of security, should the target firm fail, and that “aged” goodwill is not considered to be an asset by investors. So innovation is a total priority.

Key-Words: Goodwill, maximize the assets, risk of acquisition, security, value relevance of innovation

1 – Introduction

Most empirical research testing positive accounting theory has been based on the opportunistic or so-called ex-post perspective. This perspective relies on the assumption of self-maximization by contracting parties and the incompleteness of contracts (including ambiguity and flexibility of the rules) which allow opportunistic divergence. The efficient contracting perspective evolved from the view of Watts (1977) who conjectures that the

context of financial statements is driven by agency cost minimizing motives. Efficient ex ante accounting policy choices minimize agency costs so that the value of the firm is maximized. This perspective involves the search for accounting policy choices within the available accepted set which minimize potential conflicts between contracting parties. Holthausen and Leftwich (1983) offer the information perspective as a potential competing theory to the efficient contracting perspective. The separation of ownership and control implies that management acquires superior information to that cost effectively available to other stakeholders. This information asymmetry enables the manager to provide information regarding the firm's cash flows, to other contracting parties at a cost that is lower than they would have incurred had they sought the information themselves. While recognizing that it is difficult to separate efficient contracting and information motivations empirically, because both perspectives suggest a relation between accounting policy choices and the investment opportunity set, Holthausen (1990) justifies their separation due to different cash flow effects. He argues that the efficient contracting perspective focuses on the potential for accounting choices to increase the value of the firm through a direct cash flow effect, while the information perspective considers the extent to which accounting provides information about future cash flows without directly affecting them. Positive accounting researchers have tended to adopt either ex ante efficiency or ex post opportunistic explanations for firms' accounting policy choices (Watts and Zimmerman, 1990) assert that, as accounting policy choices are determined jointly by ex ante restrictions on the accepted set of accounting methods and the ex post exercise of management discretion, research which uses either explanation in isolation suffers from model specification error. This paper follows the suggestion of Watts and Zimmerman (1990) by investigating both ex ante and ex post explanations for the accounting treatment of goodwill, findings suggest that only recently acquired goodwill has information content, which indicates that the market perceives "older" goodwill as not having future economic benefits, and none information about innovation.

2 – The essence of Goodwill

Generally, goodwill may exist in any business and its amount will vary as the business develops and response to changes in the value of the business as a whole. Changes in the value of a business may occur for many reasons, for example changes in economic expectations, forecasts for that sector or perceived value. The value of goodwill may be constantly changing and is often highly volatile. It is therefore difficult to reach a valuation for goodwill at any point, particularly as goodwill is by definition not capable of being valued independently of the business as a whole. The only time at which the value of goodwill may be known with reasonable certainty is at the point where a cost is established in a transaction. This will happen when the business and the goodwill inherent in it are sold. Basically there are two types of goodwill. First, internally generated goodwill that results from a favorable attitude or good perception on the part of the customer toward the business due to the businessperson's reputation for honesty, fair dealing etc. The value of goodwill exists with respect to a business, whether or not that business is being sold or absorbed in a business combination. Second, the purchased goodwill where in business combination the cost of goodwill acquired must be determined before deciding the proper accounting treatment. The amount allocated to goodwill is said to be the difference between the purchase consideration for the business as a whole and the total fair value of its net resources that are identifiable and separable. Accounting for goodwill has been the subject of considerable debate over a long period of time with regard to both whether purchased goodwill is an asset that should be

recognized in the balance sheet and, when it is recognized, how it should be amortized. Accounting researchers have attempted to empirically test the extent to which the recorded goodwill asset is relevant in the valuation of equity by market participants. Prior studies have consistently found a positive association between firm value and goodwill in both the U.S. (see for example Jennings, Robinson, Thompson and Duvall, 1996) and Australia (see Godfrey & Koh, 2001). However, Jennings et al. (1996) and Henning, Lewis and Shaw (2000) suggest that investors are likely to attach different valuation weights on various components of the total goodwill asset amount, including differentiation in the value relevance of goodwill of different 'ages'. That is, goodwill may be strongly associated with expected future benefits in the period the acquisition is recorded, but is likely to diminish rapidly thereafter (Jennings et al., 1996). Although Jennings et al. (1996) find no significant differential effect between values attached to recently acquired goodwill and 'older' goodwill, this issue warrants further investigation, particularly in light of the current international debate about how goodwill should be amortized. The first area of controversy regarding goodwill centers on whether goodwill should be recorded as an asset on the balance sheet. Various researchers have addressed this question by investigating the association between purchased goodwill and the market value of the firm's equity. If the market judges that the reported amount of goodwill reflects future economic benefits, then there should be a significant positive relationship between goodwill and the firm's market value of equity. Overall, these studies conclude that goodwill is priced as an asset by investors (see Clinch, 1995).

Johnson and Petrone (1998) argue that it is possible to disaggregate purchased goodwill into six components:

- (i) the excess of the fair value of the acquirer's assets over book value;
- (ii) fair values of net assets not recognized;
- (iii) fair value of the "going concern" element of the acquirer's existing business;
- (iv) fair value of synergies arising from the acquisition;
- (v) overvaluation of the consideration by the bidder; and
- (vi) overpayment by the bidder.

The first component does not represent goodwill but represents gains in the value of assets not recognized by the acquiree. Similarly, the second component represents intangibles of the acquiree that have not been recognized perhaps due to failure to meet the recognition criteria for assets. Although these amounts should be recognized as separate assets at the time of the acquisition, the authors argue that because of difficulties in measuring the fair values of these assets these items may by default be included in the recorded measure of goodwill. Components three and four are part of goodwill and represent the acquiree's internally generated goodwill and goodwill arising from the combination respectively. Components five or six are not assets but will more than likely be included in goodwill because the measurement of goodwill is calculated as the excess of the cost of acquisition over the fair value of the net identifiable assets acquired.

As suggested by Jennings et al (1996), it is possible that the value relevance of goodwill to investors is associated with the 'age' of the goodwill balance. As the goodwill 'ages' and the future economic benefits are consumed, investors may attach a lower valuation weight to this goodwill. An interesting empirical question therefore, is whether the value relevance of goodwill declines with time since the acquisition. If goodwill is regarded as an asset of unlimited life then the value relevance of goodwill should continue indefinitely after

purchase. However, if goodwill is regarded as a wasting asset then the value relevance of goodwill should decrease over time. The research question addressed by this study is: does the value relevance of goodwill decline over time and over what period does the value relevance of goodwill persist?

3 – Research Method to identify “aged” Goodwill

As the primary focus of this study is to identify whether goodwill “ages”, it is necessary to distinguish between goodwill purchased in a particular year and goodwill purchased in earlier years. Martin Bugela and Natalie Gallery from University of Sidney 2003 suggest a Regression model (1) tests whether intangible assets in total are value relevant. The results show that consistent with prior studies, the coefficients for total tangible assets (TTA) and total liabilities (TL) are significant ($t = 7.198, p < 0.01$ and $t = -2.981, p < 0.01$ respectively). In relation to the variable of interest, the coefficient for total intangible assets (TIA) is positive and significant ($t = 4.757, p < 0.01$), indicating that intangible assets reported in financial reports are relevant to market participants. In regression model (2) intangible assets are disaggregated between net total goodwill (GWT) and identifiable intangible assets (IIA). The results show that while IIA is strongly positively related with firm value ($t = 3.709, p < 0.01$), the association with GWT is only weakly significant ($t = 1.925, p < 0.1$). These results are consistent with the findings of prior research (e.g., Jennings et al 1996, Henning et al 2000 and Godfrey & Koh 2001).

The test results for the full sample of 460 firm-year observations consistently show that goodwill acquired in the observation year is positively associated with firm value, but that association is only weakly significant, goodwill acquired in the prior and earlier years the association is generally not significant. As the materiality of goodwill relative to total firm assets is likely to influence the extent to which goodwill is associated with share price, we retest the model using sub-samples of firm-years with goodwill balances at the three materiality thresholds of two, five and ten percent. We find that irrespective of materiality level, goodwill acquired in the observation year is significant and goodwill purchased more than two years ago is not significant. Goodwill acquired in each of the prior two years is significantly associated with firm value only at or above the materiality threshold of five percent.

When goodwill is disaggregated between goodwill acquired in the year of observation and goodwill acquired in prior years in regression model (3), only goodwill acquired in the observation year (GWA_0) is weakly significant ($t = 1.884, p < 0.1$), whilst the balance of goodwill ($GWTxA_0$) is not significant. Further disaggregation of the balance of goodwill in model (4) yields similar results in that goodwill acquired in the year of observation is weakly significant ($t = 1.954, p < 0.1$) but neither goodwill acquired in the prior year ($GWA-1$) nor the balance of goodwill acquired in earlier years ($GWTxA_{0-1}$) is significant. The results for models (3 and (4) indicate that only the most recently acquired component of goodwill is considered an asset by investors, and goodwill purchased in prior years is not relevant in the valuation of firm equity. When goodwill is further segmented in Model (5), goodwill acquired in the observation year is no longer significant, and neither of the other two years is significant. However, the balance of goodwill that was purchased more than two years previously ($GWTxA_{0-2}$) is weakly significant ($t = 1.958, p < 0.1$). This result appears to contradict the results for Models (3) and (4) in that older goodwill is now shown to have information content whereas recently acquired goodwill does not. Given the weakness in the

significance levels of goodwill across all four models (2, 3, 4 and 5), the results cannot be considered as conclusive.

A possible explanation for this finding of a weak association between share price and goodwill is that for some observations goodwill relative to other firm assets is immaterial.

That is, it is expected that the strength of association with share price is higher for more material levels of goodwill. To test the proposition that only material amounts of goodwill have information content, a sub-sample of observations based on materiality of goodwill relative to total firm assets is drawn for further testing.

Regression models

To examine the relationship between equity values and accounting goodwill numbers we adopt a similar approach to Jennings et al. (1996) and Henning et al. (2000). We first estimate the following pooled cross-sectional regression equation to test whether total intangible assets are value relevant. $MVE_{i,t} = \alpha_0 + \alpha_1 TTA_{i,t} + \alpha_2 TL_{i,t} + \alpha_3 TIA_{i,t} + E_{i,t}$ (1) where MVE is the share price of firm i three months after year end reporting date t, TTA is the total tangible assets, TL is total liabilities and TIA is total intangible assets at year end reporting date t for firm i. TIA is then disaggregated into the components of total net goodwill (GWT) and identifiable intangible assets (IIA) as per the following equation: $MVE_{i,t} = \alpha_0 + \alpha_1 TTA_{i,t} + \alpha_2 TL_{i,t} + \alpha_3 IIA_{i,t} + \alpha_4 GWT_{i,t} + E_{i,t}$ (2).

We further explore whether the market values of recently acquired goodwill differ from goodwill acquired in prior years by disaggregating GWT into the components of goodwill acquired in the current year (GWA_0) and two prior years (GWA_1 and GWA_2), and the balance of goodwill for each year excluding acquisitions ($GWTxA_0$, $GWTxA_{0-1}$ and $GWTxA_{0-2}$). These components of goodwill are incorporated into the following three regression equations:

$$MVE_{i,t} = \alpha_0 + \alpha_1 TTA_{i,t} + \alpha_2 TL_{i,t} + \alpha_3 IIA_{i,t} + \alpha_4 GWA_{0,i,t} + \alpha_5 GWTxA_{0,i,t} + E_{i,t} \quad (3)$$

$$MVE_{i,t} = \alpha_0 + \alpha_1 TTA_{i,t} + \alpha_2 TL_{i,t} + \alpha_3 IIA_{i,t} + \alpha_4 GWA_{0,i,t} + \alpha_5 GWA-1_{i,t} + \alpha_6 GWTxA_{0-1,i,t} + E_{i,t} \quad (4)$$

$$MVE_{i,t} = \alpha_0 + \alpha_1 TTA_{i,t} + \alpha_2 TL_{i,t} + \alpha_3 IIA_{i,t} + \alpha_4 GWA_{0,i,t} + \alpha_5 GWA-1_{i,t} + \alpha_6 GWA-2_{i,t} + \alpha_7 GWTxA_{0-2,i,t} + E_{i,t} \quad (5)$$

In regression (3) net goodwill is decomposed into goodwill acquired in the current year and the remaining balance of goodwill. Regression (4) disaggregates this remaining balance of goodwill between goodwill acquired in the prior year and goodwill acquired two or more years earlier. In regression (5) the remaining balance of goodwill is further disaggregated into goodwill acquired two years earlier and goodwill acquired three or more years previously. Each component of goodwill is measured as the gross goodwill at acquisition less an estimated amount of amortized goodwill. Estimation of amortized goodwill is based on the disclosed amount of amortization expense for each year and the average goodwill amortization period, which is inferred from the proportion of amortization expense to total goodwill reported by the firm during the period of observation. These findings are coherent with the hypothesis of Keitha Dunstan of Queensland University of Technology Australia.

FIGURE 1
Contracting Stage and the Role of Accounting

CONTRACTING STAGE	ROLE OF ACCOUNTING	EFFICIENT OR OPPORTUNISTIC?
<i>Ex ante</i>	Pre-decision Mitigation of information asymmetry.	Efficient due to minimisation of contracting costs.
	Agreement Determination of the accepted set of accounting procedures.	Efficient because the accepted set is determined to minimise contracting costs.
<i>Ex post</i>	Adjudication Managerial choice of method from within the accepted set.	Efficient where the exercised discretion increases the wealth of all parties. Opportunistic where the wealth of one contracting party is increased at the expense of other contracting parties.

From: Accounting for Goodwill on the acquisition of corporate subsidiaries, Keitha Dunstan

HYPOTHESIS ONE

The more closely related the acquirer and target company, the greater the proportion of the ‘notional’ purchase price recorded as goodwill.

The underlying premise of Hypothesis One is that ‘operational and managerial synergy’ is generated where two companies with closely related operations are combined. The determination of whether the acquiring company and the target operations are related is based on observation of the movement in share prices of the two companies. Firms with related operations should experience similar share price reactions to industry specific and economy wide information. Examples of related takeovers include: vertical integration, where a firm acquires successive processes within the same industry; horizontal integration where a firm acquires another within the same industry sector, and; concentric acquisitions such as acquiring another company which has new technologies. Where the magnitude of ‘operational and managerial synergy’ is an increasing function of the extent of relatedness between the acquirer and the target company, and where the recognition of goodwill provides a credible indication of the value of that synergy, the amount of goodwill recognized is expected to be a function of acquirer and target company relatedness, and core competence for innovation.

HYPOTHESIS TWO

Where an acquisition generates ‘financial synergy’, by combining a company which is slack-poor with a company having free cash flow, the proportion of the ‘notional’ purchase price recorded as goodwill will be greater than where a combination of firms does not generate ‘financial synergy’.

Chauvin and Hirschey (1994) examine the determinants of the amount of recorded goodwill, as well as the association between goodwill and the profitability of the firm, and goodwill and the market value of the firm. Using a US sample drawn over the years 1989-1991, the results show a significant positive relationship between the firm’s market value and goodwill balance. This result only holds however, for firms in the non-manufacturing sector. Jennings, Robinson, Thompson and Duvall (1996) study the relationship between the market value of equity and goodwill over the period 1982 to 1988 also using a sample of US firms. The results indicate a significant positive association between goodwill and a firm’s market value after controlling for other assets and liabilities. McCarthy and Schneider (1995) investigate whether the market regards the reported goodwill figure as an asset, and also whether goodwill is priced differently from non-goodwill assets. Using a US sample drawn from the period 1988 through 1992, the results indicate that goodwill is regarded as an asset by investors. There is also some evidence that the relationship between goodwill and market

value is greater than that between non-goodwill assets and market value. Some identifiable assets encompass growth options requiring further discretionary investment (eg. brand names) and components of goodwill might be considered as assets in place (eg. firm reputation). In general, however, the 'identifiability' of intangible assets would improve as they become closer in form to assets-in-place and are therefore more observable and verifiable. Where an identifiable asset consists primarily of assets in place the measurement, book-keeping and audit costs will be low. Accounting for the acquisition of corporate subsidiaries involves the separate recognition of identifiable assets (both tangible and intangible) and goodwill. The restrictions on the accepted set would provide an acceptable range of proportional allocations of the cost of acquisition for the assets that would vary depending on the actual types of assets acquired in the transaction, and the competence for actually innovate.

HYPOTHESIS THREE

The higher the proportion of assets acquired which are growth options the higher the proportion of the 'notional' purchase price recorded as goodwill.

is therefore expected that *ex post* exercise of management discretion, within the accepted set, will vary depending on the impact of this transaction on the contracts already in place in the firm. Efficiency or opportunism may motivate the *ex post* exercise of managerial discretion within the accepted set. Watts and Zimmerman (1990) acknowledge that the exercise of *ex post* discretion will be efficient where the outcome was anticipated during the *ex ante* contracting process and the parties to the contract have been price protected. This paper predicts that there is a positive association between leverage and the allocation of the purchase price to tangible and perhaps identifiable intangible assets. This implies that there is a negative relation between leverage and the recognition of goodwill.

HYPOTHESIS FOUR

There is a negative association between the leverage of the acquiring entity and the proportion of the 'notional' purchase price recorded as goodwill.

That is, it is proposed that firms with a lower accounting rate of return would be more likely to opportunistically manage profits upwards as they would be more likely to be in an unfavorable position for any existing contracts than other more profitable firms. Therefore, firms with a low accounting rate of return are more likely to avoid the recognition/amortization of goodwill. The major flaw with a hypothesis using low accounting rate of return as a proxy for a firm's contractual discomfort is that accounting rate of return itself is likely to be driven by the investment opportunity set. For instance, Gaver and Gaver (1993) contend that firms with a high proportion of assets-in-place will generate higher accounting profits than high growth option firms. Another weakness of this hypothesis is that any relation found cannot be tied back to the specific contractual arrangements, be they debt agreements or bonus plans. There may also be alternative explanations motivating the management of earnings. Researchers provide evidence that firms manage earnings, to avoid political costs (Wong, 1988; Jones, 1991; Gerhardy, 1991; Cahan, 1992; Guenther, 1994), to mask financial distress (Murphy and Zimmerman, 1992; Pourciau, 1993; Houghton *et al.*, 1993; DeAngelo 1988, DeAngelo and Skinner, 1994) or to avoid hostile takeover/proxy contests (DeAngelo, 1988; Groff and Wright, 1989; Christie and Zimmerman, 1994). Accounting for goodwill on the acquisition of corporate subsidiaries involves the determination of the proportion of the acquisition price to be capitalised as an asset and to be subjected to subsequent amortisation.

Specification of Variables - Dependent Variable

The dependent variable is the proportion of the 'notional' purchase price that is recorded as goodwill for each individual acquisition transaction (*GOODWILL*). Where the consideration provided for the acquisition was entirely cash the cost of acquisition is determinate. However, where shares were issued as consideration, the cost of acquisition must be recorded at the fair value 'notional purchase price' which is measured as the market price of the shares one month prior to the takeover offer multiplied by the number of shares issued as consideration. This provides an objective, though arbitrary basis for estimating the fair value of the purchase consideration. Empirical and theoretical work in financial economics and strategic management has addressed the sources of wealth creation in takeovers (Dodd and Ruback, 1977; Dodd, 1980; Bradley, Desai and Kim, 1988; Berkovitch and Narayanan, 1993; Jensen, 1986). Writers such as Chatterjee and Lubatkin (1990) and Seth (1990) contend that where the acquiring and target companies operate in related industries wealth is generated through the combination of their resources at an operational level. Such operational gains include economies of scale (e.g. marketing and distribution), economies of scope, technological transfers and increased market power (Trautwein, 1990; Simmonds, 1990; Seth, 1990). A further closely related synergy that might be created through the combination of related companies is managerial synergy. Researchers contend that the market for corporate control provides a powerful mechanism for the discipline of management (Fama, 1970; Jensen, 1986; Groff and Wright, 1989; Wong, 1992). If the management team of a firm is inefficient it is likely to become a takeover target because an acquirer would be able to create wealth by replacing the incumbent management. If an acquiring firm operates in a related industry they would be in a strong position to generate such managerial gains because their existing management team would already have the necessary expertise in the area (Trautwein, 1990; Simmonds, 1990; Seth, 1990).

Conclusions

The absence of a significant relationship between the market value of equity and goodwill acquired two or more years previously suggests that older goodwill is not considered to be an asset by investors. This finding has implications for the current debate about accounting for purchased goodwill, particularly in light of the recent change in the U.S. to using an impairment test to determine the amount of goodwill amortisation expense. If the economic benefits of recorded goodwill do not extend for more than two years, then the effect of applying an impairment test is to substitute internally generated goodwill for acquired goodwill. Our findings also have implications for value relevance research. While prior studies have generally found that goodwill is viewed as an asset by the market, there is an underlying differentiation of that valuation on the basis of age, which in turn has important implications for goodwill accounting standards and practices. The overall conclusion from prior research is that goodwill is positively associated with market values. A limitation of this research is that the tests of association between goodwill and market value are based on the aggregate reported amount of goodwill. The reported amount of goodwill reflects the accumulation of goodwill arising from multiple acquisitions and is thus likely to reflect goodwill amounts of different 'ages'. Companies will still have to perform the hard work necessary to take innovation results and convert them into products and services this hard work will integrate the ideas of others with the firm's own ideas and deliver the goodwill result through the company's business model. Society will benefit if these ideas (goodwill) flow through multiple business model creating innovation channels, today it is not necessary

or even feasible to lock up vital knowledge and ideas in Silos, a world of opportunity awaits the firm, to support and exchange knowledge.

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