The Components of Purchased Goodwill in Businesses Combinations

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Abstract:

Purchased Goodwill appears when a company acquires another company. It can be defined as an intangible asset that arises as a result of the acquisition of one company by another for a premium value. International accounting standards the IASC or the FASB require acquiring firms to record goodwill as an asset when they purchase a target firm and pay more than the fair market value of the identifiable net assets of that firm.

In this paper I have tried to identify the rationale of existence the purchased goodwill and the components of it. It is viewed as a component of the purchase price that can be decomposed into certain elements that often can explain the realizing of transaction. Purchased goodwill can be interpreted as a purchase premium which is paid by the acquirer over the value of the net identifiable assets of acquire. This payment will allow the acquiring company entering into the possession of certain valuable resources for it.

Keywords: *goodwill, intangible, asset, company, acquisition, price, component*

JEL classification: G32

1. Introduction

Purchased Goodwill appears when a company acquires another company. It can be defined as an intangible asset that arises as a result of the acquisition of one company by another for a premium value.

International accounting standards the IASC or the FASB require acquiring firms to record goodwill as an asset when they purchase a target firm and pay more than the fair market value of the identifiable net assets of that firm.

As a consequence of these regulations, the goodwill appears in the accounts of a company only when it acquires certain intangible assets that are not identifiable.

Because the purchased goodwill arises in business combinations this concept is detailed in the standards on business combinations (FAS 141 and IFRS 3) rather than those on intangible assets and goodwill (FAS 142 and IAS 38).

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2. Points of view about the goodwill

According to some authors (Colley and Volkan, 1988; Johnson and Petrone, 1998) the purchased goodwill can be approached from two points of view:

- the quantitative point of view;
- the qualitative point of view;

From a quantitative point of view (named also as top-down perspective), goodwill is viewed as the part of the purchase value that is not possible to allocate to the purchased identifiable assets.

From a qualitative point of view (named also as bottom-up perspective), goodwill is viewed in terms of its components.

The top-down perspective on purchased goodwill

Goodwill can be first considered from a top-down perspective. From an accounting point of view purchased goodwill is viewed as a residual component of the purchase price that arises when the purchase price paid by the acquiring firm exceeds the fair value of net identifiable assets, tangible and intangible, of the target company.

The SFAS No. 141 and IAS 3 require the acquiring company to record separately in its balance sheet the identifiable tangible and intangible assets of the acquired company at their fair values. The excess of acquisition price over the fair values of the acquired entity's net assets is recorded as goodwill.

Goodwill is defined as the excess of the cost of an entity over the net of the amounts assigned to assets acquired and liabilities assumed (SFAS No. 141, par. 43). IFRS 3 (2004) view goodwill as an excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost.

According to accounting standards (SFAS No. 141, IFRS 3) goodwill results if the cost of the business combination is higher than the sum of the fair values of the assets acquired minus the sum of the fair values of the liabilities and contingent liabilities assumed in the course of a business combination. As a result of the residual nature of goodwill, the higher amount of intangible assets and the lower amount of contingent liabilities recognized, the lower is the residual amount of goodwill.

The amount of goodwill is separately recorded as an asset in the balance sheet of the acquiring company. This implies that the goodwill arising from an external acquisition is accounted for, whereas internally generated goodwill is not.

IFR 3 (2004) define goodwill as an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. According to this definition the goodwill is still defined as a residual asset since it relates to the benefits that cannot be attributed to individual assets.

The bottom-up perspective on purchased goodwill

Important questions in the acquisition process are the following:

- why an investor is willing to pay more than the value of the net identifiable assets of the target company?
- how can be explained these purchase premiums that are paid for the purchased companies and are recorded as goodwill in the financial statements of the purchasers?

Accordingly to *bottom-up perspective* goodwill can be interpreted as a *purchase premium* which is paid by the acquirer over the value of the net identifiable assets of acquire with good reasons. This payment will allow the acquiring company entering into the possession of certain valuable resources for it.

The purchased goodwill is viewed as a component of the purchase price that can be decomposed into certain elements that often can explain the realizing of transaction.

According to Johnson and Petrone (1998) and Henning et al. (2000), aggregate goodwill can be divided in the following four elements:

1. Fair value of the *going-concern element* of the target firm's business or *Going-Concern Goodwill;*
2. Fair value of the synergies between the acquirer firm and the target firm's businesses or *Synergy Goodwill*;
3. Payments resulting from *over*- or *under-valuation* of the cost of the business combination;
4. *Overpayment* (or *underpayment*) for the target firm.

Going Concern Goodwill

According to Johnson and Petrone (1998, p. 295) an important component of the purchased goodwill is *the fair value of the `going-concern` element* of the target company`s existing business. This was named the *going-concern element* (or *going concern goodwill*) and was defined as the ability to earn a higher return on a collection of assets than would be expected if those assets were acquired separately.

Johnson and Petrone (1998) highlighted that goodwill reflects „the synergies of the net assets of the business and factors related to market imperfections, such as where a business has the ability to earn monopoly profits or where there are barriers to entry to the market by potential competitors."

The going concern goodwill represents the stand-alone value of economic benefits arising from the combined net assets of the target firm (Johnson and Petrone, 1998; Roychowdhury and Watts, 2007).

The sources of internally generated goodwill can be grouped into two categories:

- synergies between identifiable assets of the company;
- the unidentifiable intangibles that cannot be recognized separately in financial situations of the companies.

The sources of internally generated goodwill are represented by many unidentifiable intangible assets that significantly contribute to the creation of profit and value at the level of the company but do not meet the accounting recognition criteria.

These include human resources, business's reputation, business's relationships (with customers, suppliers, business partners, lenders), business organization, unique market position; good location; outstanding credit ratings; favourable government regulations; efficient commercial channels etc.

Synergy Goodwill

According to Johnson and Petrone (1998) an important component of purchased goodwill is the fair value of synergies obtained by combining the acquirer's and target's assets and operations. This was named as *combination goodwill* or *synergy goodwill* (Henning et al., 2000) and reflects the value that arises from expected synergies between the acquirer and the target firm.

These synergies are considered a very important component of goodwill**.** The standards on business combinations (FAS 142 and IFRS 3) highlight that the purchased goodwill includes the fair value of the expected synergies and other benefits from combining the acquiree's net assets with those of the acquirer. This represents the additional value generated as result of businesses combination.

This value is unique to each combination (Johnson and Petrone, 1998**)** and different combinations produce different synergies and, hence, different values.

Over- or under-valuation of the cost of the business combination

According to the work of Johnson and Petrone (1998) and Henning et al. (2000), purchased goodwill includes also the payments resulting from over- or under-valuation of the consideration used in the acquisition (consideration element);

This component is related by errors that are made in measuring the fair value of either the cost of the business combination or the acquiree's identifiable assets, liabilities or contingent liabilities (IFRS 3, 2004).

These errors can be the result of over optimistic or too pessimistic projections made by the acquiring company.

Overpayment or Underpayment

Obviously, a reason that can explains the differences between the acquisition price and value of identifiable net assets of the target company is that management of the acquirer overpaid or underpaid.

Johnson and Petrone (1998) and Henning et al. (2000) highlighted that other component of the goodwill is represented by purchase premiums paid (or discounts obtained) in the course of acquisition negotiations (purchase price element).

An overpayment "may occur when the price is driven up in the course of bidding for the target firm (Johnson & Petrone, 1998: 29).

Danaher Corp. (2008: 66) explains that the goodwill arises because of "factors including […] the competitive nature of the process by which the company acquired the business […]."

SFAS 141 highlight that other component of the purchased goodwill is the overpayment (or underpayment) by the acquirer, which might arise from situations, when one or more bidders are competing for the target (overpayment), or from distress or fire sales (underpayment).

The overpayments represent premium paid without any future economic benefit **(**Giuliani& Brännström, 2015**).**

3. Core Goodwill and Residual Goodwill

The purchased goodwill recognized in financial statements of the acquiring company can be divided in two categories*: core goodwill* and *residual goodwill***.**

The reason why an investor is willing to pay more for a company than the value of its net identifiable assets is related by the additional future economic benefits that can be generated as result of acquisition.

Commonly, purchased goodwill is regarded as the present value of the additional profits the acquiring company is expecting to gain in the future as result of target company`s acquisition.

These additional future economic benefits can be extracted from two sources:

- the remaining intangible assets that do not qualify for separately recognition in the financial statements of the acquirer;
- the synergies estimated to be generated as result of businesses combination.

In external reporting, goodwill is the sum of the all four components previously mentioned since it is determined as difference between the purchase price and the value of all identifiable intangible assets of the target company.

According to Johnson and Petrone (1998), from an economic (conceptual) point of view, only *going-concern goodwill* and *combination goodwill* are considered parts of goodwill and, combination of these two components is called as *core goodwill*.

Johnson and Petrone (1998) and Henning et al. (2000) highlighted that only the components of the core goodwill are considered to be assets by shareholders.

The *going concern premium* and *the synergy value* are identified also by FAS 141 and IFRS 3 as *core* or *true goodwill.*

According to SFAS 141, goodwill values should embody essentially two elements (referred to as "core goodwill"):

- the fair value of the going concern of the target's business,
- the fair value of the synergies expected from combining the companies.

The calculation of purchased goodwill as a residual element of purchase price implies that this can include other part named by the Henning et al. (2000) as *residual goodwill.*

According to Johnson and Petrone (1998).and Henning et al. (2000) the residual goodwill comprises the last two elements of the purchased goodwill:

- overvaluation of the consideration paid by the acquirer:
- overpayment for the target.

The residual goodwill is not regarded as an asset by the investors.

Conclusions

Purchased Goodwill appears when a company acquires another company. It can be defined as an intangible asset that arises as a result of the acquisition of one company by another for a premium value.

The purchased goodwill can be approached from two points of view.

From a quantitative point of view (named also as *top-down perspective*) purchased goodwill is viewed as a residual component of the purchase price that arises when the purchase price paid by the acquiring firm exceeds the fair value of net identifiable assets, tangible and intangible, of the target company.

The SFAS No. 141 and IAS 3 require the acquiring company to record separately in its balance sheet the identifiable tangible and intangible assets of the acquired company at their fair values. The excess of acquisition price over the fair values of the acquired entity's net assets is recorded as goodwill.

As a result of the residual nature of goodwill, the higher amount of intangible assets and the lower amount of contingent liabilities recognized, the lower is the residual amount of goodwill.

From a *qualitative point of view* (named also *bottom-up perspective*) goodwill can be interpreted as a *purchase premium* which is paid by the acquirer over the value of the net identifiable assets of acquire with good reasons. This payment will allow the acquiring company entering into the possession of certain valuable resources for it. Purchased goodwill represents the value of all unidentifiable intangible assets that are obtained as result of the acquisition of another company and that can contribute to generating of additional economic benefits. According to *bottom-up perspective* purchased goodwill can be defined in terms of its components.

The purchased goodwill recognized in financial statements of the acquiring company can be divided in two categories*: core goodwill* and *residual goodwill*. Johnson and Petrone (1998) and Henning et al. (2000) highlighted that only the components of the core goodwill are considered to be assets by shareholders.

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