

Innovative methods of evaluating goodwill in increasing the competitiveness of the company

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Introduction

One of the criteria for successful business management can be defined as reliable information about all existing assets. The key role in this context is the measurement of intangible resources which are not always reflected in the financial reporting but have a significant influence on the financial stability. One of the essential assets that have significant impact on the investment attractiveness of the enterprise is goodwill. Due to its interpretation and variation in approaches, goodwill generates plenty of discussions and is one of the most problematic research question in general accounting methodology. This is true not only for Ukraine but throughout the world. Currently there is not enough research on the recognition and valuation of goodwill in economic literature and regulations governing measurement of the intangible assets, confirming the importance of this study.

The aim of our research is to improve the assessment regulations for goodwill from the perspective of a modern economic environment. There is a lack of unique verified methods for assessing goodwill so that critical analysis of methods for valuation of intangible assets needs to be conducted. The important task is to identify the criteria of the impairment of goodwill testing (considering the subjectivity impact) and to create definition of internally generated goodwill under conditions of fuzzy information.

The methods of the research. The study used the general scientific and special methods of learning: generalization – for determining and disclosing the essence of the concept of „goodwill”; comparison, group – for the analysis and comparison methods for valuation of goodwill; specification – for identifying promising solutions to issues in the recognition of goodwill valuation.

Theoretical and methodological basis of the paper are the international financial reporting standards, laws and legal documents on IFRS implementation in Ukraine, scientific works of domestic and foreign scientists, proceedings of the conference, international projects.

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Results and Discussion. Goodwill and its components such as level of quality control, reliability, buyers, trade secret, highly skilled workers and research are not reflected in the financial statements. However, many researchers insist the correct and appropriate assessment should help to show them as assets in financial reporting. V. Kitchel [1996: 34–35] tells that more and more companies realize that their advantage is not in the hardware but intangible assets such as the brain power of a corporation. American professor D. Quinn [Stewart 1994: 23–24] suggests that three-quarters of value added in manufacturing is obtained through knowledge. Existing restrictions on the recognition and measurement of certain types of intangible assets do not allow them to be recognized as an object of accounting.

The need for valuation of goodwill

Regarding the necessary valuation of intangible assets, opinions of individual scientists are diametrically opposed. Australian Professor Raymond Chambers [1966: 398–399] argues that intangible assets are evaluated only in combination with tangible assets and therefore they must be considered as a residual benefit that remains after deducting all tangible assets. Intangible assets can't be separated from the company and evaluated under current monetary terms and must be written off immediately after the acquisition. Considering opinion of Raymond Chambers, intangible assets can be traded and therefore state the object of evaluation. Moreover the need for valuation of intangible assets, including goodwill, confirms significant influence on the market value of an enterprise as a whole. Thus for global companies «Coca-Cola» and «British Petroleum», the ratio of tangible and intangible assets is 4:96 and 29:71, respectively [*Best global brands, Interbrand*, 2014]. A positive corporate image for global corporations is important as it is a factor in approximately 97% of investments. As the goodwill value of the enterprise can be material, it is important to calculate the proper value.

There are many reasons why a financial adviser may be asked to value goodwill. Some of these reasons follow [Robert F. Reilly 2015: 10–12]:

1. *Economic damage analyses.* When a business has suffered a breach of contract or a tort (such as an infringement, breach of a fiduciary duty, or interference with business opportunity), one measure of the damages suffered is the reduction in the value of the entity's goodwill due to the wrongful action.

This analysis may encompass the comparative valuation of the entity's goodwill before and after the breach of contract or tort. This before and after method is also useful for quantifying the economic effects of a prolonged labor strike, a natural disaster, or a similar phenomenon.

2. *Business or professional practice merger.* When two businesses merge, the equity of the merged entity typically is to be allocated to the merger partners. One common way to allocate equity in the merged entity is in proportion to the relative value of the assets contributed, including the contributed goodwill.

3. *Business or professional practice separation.* When a business separates, the assets of the consolidated business typically have to be allocated to the individual business owners.

One common way to allocate the assets to the separating business partners is in proportion to the relative value of the assets controlled by or developed by each partner, including the goodwill of each business partner.

4. *Solvency test.* The solvency of a business entity is an issue with regard to lender's fraudulent conveyance concerns during a financing transaction or a financial restructuring.

One of the individual tests to determine if a business entity is solvent is: Does the fair value of the entity's assets exceed the value of the entity's liabilities (after consideration of the financing transaction)? One of the entity's assets that is considered in a solvency analysis is goodwill.

5. *Insolvency test.* The degree of insolvency of a business entity may have federal income tax consequences if debt is forgiven (in whole or in part) during a refinancing transaction or financial restructuring. One of the specific tests to determine if a business entity is insolvent for federal income tax purposes is: Is the fair market value of the entity's assets less than the value of the entity's liabilities (before the debt forgiveness)?

6. *Intercompany transfer price.* When intangible assets are transferred between related entities (for example, between a parent corporation and a less than wholly owned subsidiary), an arm's-length price should be estimated for the intercompany transfer of the assets.

Such an intercompany transfer may affect the profitability and return on investment of, say, two subsidiaries—one that is wholly owned and one that has a 10 percent minority interest owner.

7. *Bankruptcy and reorganization.* Parties in interest to a bankruptcy estate often have to decide if the debtor corporation is worth more as a going-concern business (pursuant to a plan of reorganization) or as a mass disposition of assets (pursuant to a plan of liquidation). A valuation of the debtor's goodwill (if any) may be useful in assessing whether the business is worth reorganizing.

8. *Conversion of a C corporation to an S corporation.* One factor in the analysis of the costs and benefits of converting an entity's federal income tax status from a C corporation to an S corporation is the quantification of any built-in gains (BIG) tax associated with the value of the corporation's assets.

9. *Business enterprise valuation.* The identification and quantification of goodwill is one procedure of the asset-based approach to business valuation. An asset-based approach is often used in the valuation of an industrial or commercial company or professional service business.

10. *Deprivation analysis.* The goodwill valuation may be one component in the damages analysis associated with a business that is subject to a condemnation, expropriation, or eminent domain action. Financial advisers sometimes only consider the value of the entity's real estate and tangible personal property subject to the condemnation or other „taking”.

11. *Ownership allocation litigation.* Several forms of litigation involve the allocation of direct or indirect ownership interests in a business entity. Two examples of such litigation include the following: marital dissolution cases (which involve the allocation of the business entity ownership interest within the marital estate).

12. *Ad valorem property tax*. In some taxing jurisdictions, state and local ad valorem property tax only applies to real estate and tangible personal property. The existence of economic obsolescence (a form of external obsolescence) may have a direct effect on the value of the taxpayer's real estate and tangible personal property. Accordingly, an assessment of the existence of economic obsolescence may be an important procedure in the valuation of such industrial or commercial operating property.

The main methods of goodwill valuation

The FASB and the IASB both stipulate an impairment review for goodwill valuation. Goodwill impairment can be reasonably valued using an appropriate application of any one of the four methods discussed below [Becker, Sperduto, Riedy 2002].

Market Capitalization Method. The company's market capitalization is added to the company's liabilities to arrive at its enterprise value. The value of all tangible and other intangible assets is then subtracted from the enterprise value to compute the worldwide value of goodwill.

This method of goodwill valuation is the most criticized among all the methods. Critics say it is too difficult to separate out the values of the various types of intangibles. Moreover, the market capitalization of a firm includes current and expected future intangibles, while the firm's value will only include current intangibles. However the market capitalization is theoretically sound and these criticisms are generally unfounded.

Declining Royalty Approach. This method is commonly used in the related party buy-in/cost sharing context. The royalties generated/paid is used as a proxy for value. It assumes that without continued development, intangibles lose value over time. In essence, the approach determines the market price (royalty rate) for goodwill throughout its useful life. It theoretically determines the royalty payment during any specific year of the intangible useful life in the following three steps: Defining the market royalty rate for the intangible based on benchmarks, profitability or some other measure; estimating for each year of the intangible's useful life in the future, the portion of the intangibles value in that year that has already been developed and multiplying the value computed in the two previous steps to determine declining royalty rates for each year remaining in the intangible's useful life.

Discounted Cash Flow Method. This is the most commonly used and taught methodology. It is quite common in valuing entire businesses and in valuing goodwill in M&As. It simply gives the present value on the future expected cash flows using a discount rate. The process is very direct for valuing businesses but some controversy surrounds the validity of projections as well as the appropriate discount rate. In applying the discount cash flow to goodwill valuation, one does not determine the total cash flows of the company or investment, rather it is the incremental cash generated by goodwill. The difference in the company's cash flow with and without the use of its goodwill defines the cash flows that would be discounted in goodwill valuation.

Benchmark Comparisons. This method looks at acquisition studies and publicly available metrics that, determine the ratio of intangible value to market value for simi-

lar companies. If acquired companies are functionally similar to the company that is being valued, their ratios of goodwill/total value and intangibles/total value may serve as broad benchmarks in goodwill valuation. These estimates are also perceived by investors to be trustworthy indicators of value.

Fair value may be defined as the price at which an asset or liability could be exchanged in current transaction between knowledgeable unrelated willing parties when neither is acting under compulsion [Khurana, Myungsun 2003: 19–42]. The FASB and the IASB recently adopted a fair value approach to financial reporting. This was met with a lot of resistance as lots of controversy surrounds fair value measurement.

According to Sayther [Sayther 2004: 6], fair value accounting clearly creates the potential for intentional and unintentional bias. The Enron case is a glaring example of intentional bias. Sayther says “The beginning of the end for Enron was its ability to manipulate fair value calculations to its advantage recording revenue on transactions that would not be profitable for several years out”.

Moreover, fair value models require lots of assumptions and every assumption a company makes is subject to second guessing by auditors, regulators and the press. Proponents of fair value accounting however claim with the passage of time historical cost becomes irrelevant in assessing present liquidity, as such the need for fair value in financial reporting.

Critical analysis of methods for goodwill valuation

Currently there is no single approach to evaluate goodwill, but scientists have developed several methods of calculation internally generated goodwill: the method of excess profits, method of surplus resources, method of volume sales. Methods of company «Branch Finance» and «Interbrand», qualimetric method, multiplicative method, method of opinion polls (Table 1).

After the first valuation of goodwill we need to make the impairment testing. It is done in two discrete parts. First part the fair market value of the reporting unit is calculated. This valuation is done as of a specific date and must be repeated annually at the same time each year. The fair market value is compared to the carrying value of the reporting unit. If the fair market value is equal to or greater than the unit's carrying value, then goodwill of the reporting unit is not considered to be impaired. Thus, the first part of the impairment test is not necessary. Alternatively, “if the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss, if any” [Brutting, Milena 2011: 28–29].

In this part, the implied fair market value of goodwill is estimated and compared to the carrying value of goodwill for the reporting unit. If the carrying amount of goodwill exceeds its implied fair market value, an impairment loss equal to this excess is recorded. The recorded loss cannot exceed the carrying amount of goodwill. After a goodwill impairment loss is recorded, the adjusted carrying amount of goodwill becomes the new accounting basis for subsequent goodwill impairment tests.

Table 1. The critical review of the main methods of assessment of goodwill

Title	Method	Advantages	Disadvantages
<i>The method of excess profits</i>	Calculation of industry average profit of assets and comparative analysis with the investigated company.	Divided cost on amount tangible assets and goodwill. Availability economic benefits from goodwill in business.	The method is not universal. Not always possible determine the right and income of capitalization factor.
<i>Method of surplus resources</i>	Comparison between actual market value of the resources and their nominal value.	The method is suitable for evaluation companies before their sale.	The basis of receipt profit make not only the net assets. Excess resources formed not only by own expense.
<i>Method of volume sales</i>	Determination of goodwill as the difference between net operating profit and sales volume multiplied by a factor of profitability.	The method is suitable for determining the current reputation.	In calculating not included the specificity of products.
<i>Methods of company «Branch Finance» and «Interbrand»</i>	Definition reputation as a brand that helps businesses get more profit compared to sales of „non branded” products.	Enhancing the role of the brand, the opportunity to participate the employee of enterprises in the formation and corrections brand.	Can not be determined sometimes absolute size of profitability.
<i>Qualimetric method</i>	Making the analogy between the utility of the company and value of created goodwill.	Expands capabilities of internal potential of business.	Goodwill consists of the relative and absolute indicators that are not right in terms of mathematics calculations.
<i>Multiplicative method</i>	Determination of the profit which equals the corporate reputation of enterprises.	Evaluation of the internal reputation of the company. The ability to calculate current and future profits.	The need for modifications of method in order avoiding unilateral vision.
<i>Method of opinion polls</i>	Learn opinion of stakeholders about companies.	The main method that gives analytical assessment of reputation of the company.	Methods give limited assessment: „positive” or „negative”, „better” or „worse”. More that misstatements depends on the volume of sample.
<i>Rating method</i>	The rankings of companies by independent reputation organizations.	Independent examination. Avoiding fraud.	Subjectivity of independent reputation organizations.
<i>Method of expert procedures</i>	Formation of reputation assessment by interviews with shareholders.	Infidelity counting in critical condition business.	Subjective factor.
<i>Statistical method</i>	Using business activity of the company.	Evaluation of business activity based only level of sales.	This kind of evaluation has a high level of risk.

* Based on: Chernykh 2012: 196–199

Existing methods for determining the present value of the business reputation of the company are not universal, it does not include items such as goodwill skills, reputation of top management, favorable economic situation and so on. In addition, goodwill can be assessed by experts based on evaluation ethics in relationships with partners (obligations, responsibilities, credit history, honesty, openness), ethics in relationships with internal partners (liability of managers to shareholders, financial „transparency” businesses), performance management (profitability, innovation, market expansion, etc.), product quality, service, reputation heads.

Conclusions

Goodwill is strategically important asset, as it is expressing the value of reputation of the company. However, the value of goodwill is not always justified, since the transaction of sale is probable influence of subjective factors such as ignorance of parties to the agreement, false assessment of available assets and so on. Therefore, the objective is the need to assess internal goodwill as a tool to increase the competitiveness of the company. Companies should independently determine and evaluate existing components of internal goodwill after recognition and fair evaluation of all other tangible and intangible assets, their impact on the amount received in cash flow and earnings. The received information will become the *foundation* of assessing the quality of management and influence on their decisions, the financial results and the increasing the competitiveness of the enterprises.

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Innowacyjne metody oceny wartości firmy wobec rosnącej konkurencyjności przedsiębiorstwa

Streszczenie

Głównym celem artykułu jest zaprezentowanie innowacyjnych metod oceny wartości firmy wobec rosnącej konkurencyjności przedsiębiorstwa. Wśród naukowców nie ma jednoznacznej opinii dotyczącej wyboru najlepszej z nich. Realizacja tego celu wymagała podziału artykułu na kilka części. Wyjaśniono pojęcie „wartość firmy” oraz zaprezentowano elementy ją tworzące. Szczególną uwagę poświęcono przedstawieniu metod wyceny przedsiębiorstwa, uwzględniając ich zalety i wady oraz możliwość zastosowania praktycznego.

Słowa kluczowe: konkurencyjność, wycena firmy, wartość firmy, zarządzanie strategiczne