Complex Made Simple

What is Goodwill?

Executive Summary

In our opinion, FASB's analysis of goodwill provided in Basis for Conclusion of FAS 141, *Business Combinations* provides well-structured and cohesive conceptual understanding of goodwill. This understanding can be used in addressing practical valuation and accounting questions related to transactions with businesses.

Conceptually, according to FASB's analysis, goodwill has two components. One component is the fair value of the going concern element of the acquiree's existing business. This value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, etc.). Second goodwill component reflects the fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. In short, goodwill includes two types of synergies that can be referred to as "internal" and "external". Note that the impact of market participant synergies is included in estimated fair value of net assets and, therefore, is excluded from goodwill.

Current accounting guidance in ASC 805, *Business Combinations* includes specific requirements so that practical calculations of goodwill do not include certain components, which are not considered part of goodwill, based on FASB's conceptual analysis.

Conceptual understanding of goodwill helps address a number of valuation and accounting questions, including those related to preparation of prospective financial information (PFI), estimating fair of purchase price in all-stock transactions and allocation of goodwill to reporting units.

Conceptual Understanding of Goodwill

Conceptual definition and practical calculations of goodwill have been subject to long and extensive debates among accounting and valuation professionals. In fact, it seems that many folks not involved with accounting and valuation professionally have an opinion as to what goodwill is and what it is not. In our opinion, FASB analysis of goodwill provided in Basis for Conclusion of FAS 141, *Business Combinations* provides well-structured and cohesive understanding of the matter. We provide a copy of this analysis without any changes in the section below. We believe that the analysis initially issued in 1999 continues to be one of the primary sources for understanding of what goodwill is and how it should be calculated for financial reporting purpose.

One of the analysis conclusions is that, conceptually, goodwill has two components, referred to as component 3 and component 4. Component 3 is the fair value of the going concern element of the acquiree's existing business. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, etc.). Component 4 reflects the fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. In short, goodwill includes two types of synergies that can be referred to as "internal" and "external".

Fair value of net assets is determined using fair value guidance per ASC 820, *Fair Value Measurements*. ASC 820 emphasizes that fair value is a market-based measurement, not an entity-specific measurement (ASC 820-10-05-1B). Therefore, the impact of market participant synergies is included in fair value of net assets and is excluded from goodwill. Market participant synergies are synergies that are available to more than one market participant while buyer-specific synergies are synergies that are available only to a specific acquirer[1].

Current accounting guidance in ASC 805, *Business Combinations* includes specific requirements so that practical calculations of goodwill do not include certain components, which are not considered part of goodwill, based on FASB's analysis. These components include the following:

Component 1—The excess of the fair values over the book values of the acquiree's net assets at the date of acquisition.

Component 2—The fair values of other net assets that the acquiree had not previously recognized.

Component 5—Overvaluation of the consideration paid by the acquirer stemming from errors in valuing the consideration tendered.

First component is excluded from goodwill due to the accounting requirement to measure assets and liabilities of the acquired business at fair value, subject to certain exceptions.

Second component is not included in goodwill as companies are required to recognize, as part of purchase price allocation, separately identifiable intangible assets, separately from goodwill.

Lastly, acquirers are required to measure the purchase consideration at fair value, which ensures that overvaluation or undervaluation of purchase price (or acquiror-specific valuation of the purchase price) is not included in goodwill.

Under ASC 805, overpayment or underpayment by the acquirer, represented by component 6 is not excluded from goodwill calculations. However, the impact of such factors is excluded from the concept of "core goodwill", which includes component 3 and 4, mostly represented by internal and external synergies[2].

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[1] See section 7.2.3.2 Market participant synergies, PwC guide Fair Value Measurements

[2] Acquirer's overpayment for the acquired business will result in the increased value of goodwill and, thus, likely in impairment, i.e., subsequent reduction of goodwill.

Similar to core goodwill, AICPA guide Assets Acquired to Be Used in Research and Development Activities provides definition of economic goodwill, as follows:

> *For purposes of this guide, economic goodwill is defined as the residual goodwill that would result from subtracting fair value of assets and liabilities from the fair value of the acquired entity as opposed to from the purchase price.*

The above conceptual understanding of goodwill gives helpful guidance in resolution of certain practical accounting and valuation questions related to transactions with businesses.

We describe some of these practical questions in section **Practical Application** below.

Statement of Financial Accounting Standards No. 141[3]

B313. The FASB's 1999 and 2001 Exposure Drafts listed six components of the amount that in practice under authoritative guidance in effect at that time had been recognized as goodwill. The IASB's ED 3 included a similar, but not identical, discussion. The components and their descriptions, taken from the FASB's Exposure Drafts were:

- Component 1—The excess of the fair values over the book values of the acquiree's net assets at the date of acquisition.

- Component 2—The fair values of other net assets that the acquiree had not previously recognized. They may not have been recognized because they failed to meet the recognition criteria (perhaps because of measurement difficulties), because of a requirement that prohibited their recognition, or because the acquiree concluded that the costs of recognizing them separately were not justified by the benefits.

- Component 3—The fair value of the going concern element of the acquiree's existing business. The going-concern element represents the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry—either legal or because of transaction costs—by potential competitors).

- Component 4—The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. Those synergies and other benefits are unique to each combination, and different combinations would produce different synergies and, hence, different values.

- Component 5—Overvaluation of the consideration paid by the acquirer stemming from errors in valuing the consideration tendered. Although the purchase price in an all-cash transaction would not be subject to measurement error, the same may not necessarily be said

[3] https://fasb.org/Page/Document?pdf=aop_fas141r.pdf&title=FAS%20141%20(Revised%202007)%20(as%20amended)

of a transaction involving the acquirer's equity interests. For example, the number of common shares being traded daily may be small relative to the number of shares issued in the combination. If so, imputing the current market price to all of the shares issued to effect the combination may produce a higher value than those shares would command if they were sold for cash and the cash then used to effect the combination.

• Component 6—Overpayment or underpayment by the acquirer. Overpayment might occur, for example, if the price is driven up in the course of bidding for the acquiree; underpayment may occur in a distress sale (sometimes termed a fire sale).

B314. The Boards observed that the first two components, both of which relate to the acquiree, conceptually are not part of goodwill. The first component is not itself an asset; instead, it reflects gains that the acquiree had not recognized on its net assets. As such, that component is part of those assets rather than part of goodwill. The second component also is not part of goodwill conceptually; it primarily reflects intangible assets that might be recognized as individual assets.

B315. The fifth and sixth components, both of which relate to the acquirer, also are not conceptually part of goodwill. The fifth component is not an asset in and of itself or even part of an asset but, rather, is a measurement error. The sixth component also is not an asset; conceptually it represents a loss (in the case of overpayment) or a gain (in the case of underpayment) to the acquirer. Thus, neither of those components is conceptually part of goodwill.

B316. The Boards also observed that the third and fourth components are part of goodwill. The third component relates to the acquiree and reflects the excess assembled value of the acquiree's net assets. It represents the preexisting goodwill that was either internally generated by the acquiree or acquired by it in prior business combinations. The fourth component relates to the acquiree and the acquirer jointly and reflects the excess assembled value that is created by the combination—the synergies that are expected from combining those businesses. The Boards described the third and fourth components collectively as "core goodwill."

B317. This Statement tries to avoid subsuming the first, second, and fifth components of goodwill into the amount initially recognized as goodwill. Specifically, an acquirer is required to make every effort to: a. Measure the consideration accurately (eliminating or reducing component 5) b. Recognize the identifiable net assets acquired at their fair values rather than their carrying amounts (eliminating or reducing component 1) c. Recognize all acquired intangible assets meeting the criteria in paragraph 3(k) of this Statement so that they are not subsumed into the amount initially recognized as goodwill (reducing component 2).

B318. In developing Statement 141 and IFRS 3, the FASB and the IASB both considered whether "core goodwill" (the third and fourth components) qualifies as an asset under the definition in their respective conceptual frameworks. (That consideration was based on the existing conceptual frameworks. In 2004, the FASB and the IASB began work on a joint project to develop an improved conceptual framework that, among other things, would eliminate both substantive

and wording differences in their existing frameworks. Although the asset definition is likely to change as a result of that project, the Boards observed that nothing in their deliberations to date indicates that any such changes are likely to call into question whether goodwill continues to qualify as an asset.)

Practical Applications

Preparation of Prospective Financial Information (PFI)

Valuation specialists use PFI or a financial forecast as part of a valuation exercise especially in part related to application of market approach. Generally, buyer-specific synergies are excluded from fair value measurements and, therefore, their impact should be excluded from PFI as well. The concept of excluding buyer-specific synergies is well understood in the valuation practice as the synergies represent a component of PFI that would likely to be clearly distinct from projections prepared specifically for the acquired business on a stand-alone basis. Excluding entity-specific or “internal” synergies is more complicated. Conceptually, PFI should be prepared assuming that acquirees assets operate on a stand-alone basis, i.e., ignoring synergies arising from combining various assets together.

One of steps taken to exclude entity-specific synergies is to determine the fair value of assembled workforce (AWF) and exclude workforce contribution to PFI by virtue of applying a contributory charge when using Multiple Period Excess Earnings Method [4].

For example, let’s assume that Debt Free Net Income (i.e., EBIT less Taxes) projected for year 1 after the acquisition is estimated to be $ 1,000, fair value of AWF is estimated to be $ 100 with 15% expected return rate. Year 1 Debt Free Net Income does not include any buyer-specific synergies. Year 1 Debt Free Net Income adjusted for the impact of AWB would be determined as $ 1,000 – 0.15 * $ 100 or $ 985. In this case, $ 985 would be used as an approximation of PFI that excludes entity-specific and buyer-specific synergies.

Note that, according to existing requirements in ASC 805, assembled workforce is considered part of goodwill (ASC 805-20-55-6).

In our opinion, full exclusion of entity-specific synergies from PFI presents a number of practical challenges. Therefore, making sure that “internal” synergies are included in goodwill and not identifiable assets is not an easy task.

Estimating Fair Value of Shares Transferred

Let’s assume Company B, the acquirer, acquired Subsidiary A from Company A in all-stock transaction. As part of the transaction, Company B issues shares constituting 30% of its capital in exchange for 100% shares in Subsidiary A. Diagrams below illustrates the exchange transaction.

Exchange transaction:

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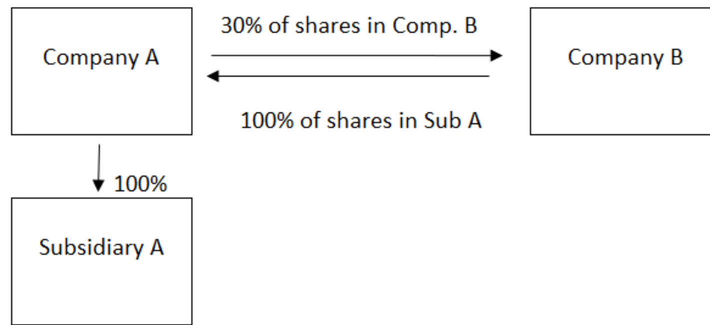
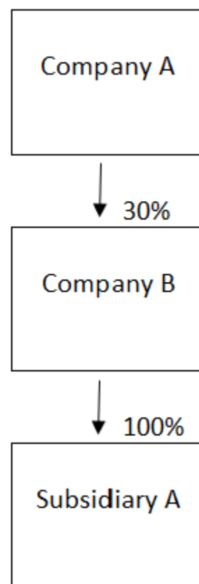
[4] See par. 2.2.14 of Contributory Asset publication issued by the Appraisal Foundation



After the transaction:



The question is how to determine the fair value of the purchase consideration and goodwill.

ASC 805 requires calculating of goodwill as the difference between the fair value of the purchase consideration and fair value of net assets acquired, ignoring non-controlling interest. From this perspective, a valuation specialist will need to estimate both fair value of the acquired business as well as the fair value of the acquirer. Fair value of the acquired business will be used to determine fair value of intangible assets (e.g., by using Multiple Period Excess Earnings Method) and to perform certain reasonableness checks (e.g., by comparing IRR with WACC). Fair value of the acquirer will be used to determine the fair value of the purchase price. Specifically, purchase price is represented by 30% of equity interest in the acquirer.

Some reporting entities noted that fair value of issued equity interest may be determined indirectly by reference to fair value of equity acquired. An argument can be made that assuming the exchange was performed by knowledgeable market participants, as defined in ASC 820-10-20, *Glossary*, the two sets of exchanged shares should have the same fair value. In other words, an exchange on market terms assumed the exchange of equal value.

If in the above example fair value of issued shares can be determined indirectly, i.e., by reference to acquired shares, it will reduce the amount of time and effort needed to perform the overall valuation exercise. This is because the acquirer will have to estimate the fair value of acquired business as part of purchase price allocation per ASC 805.

The proposed approach of performing only one valuation, i.e., the value of acquired business ignores instances of overpayment or underpayment by the acquirer. These instances are specifically discussed as one of components of goodwill in par. B313 of FASB 141. Ignoring potential overpayment or underpayment results in calculation and recognition of "core goodwill" or "economic goodwill", not "accounting goodwill", required to be recognized under ASC 805. Note that ASC 805 or ASC 820 do not include a measurement exception that would allow to measure the fair value of the consideration transferred by the fair value of consideration received except for fair value measurement as it would apply to asset acquisitions, not business acquisitions, per ASC 805-50-30-2.

Given current definition of goodwill, in share exchange transactions, companies need to measure separately fair value of equity interest transferred and received.

Allocation of Goodwill to Reporting Units

Goodwill acquired in a business combination must be assigned to one or more reporting units at the acquisition close date. How goodwill is assigned is likely to impact subsequent assessment of goodwill for impairment. ASC 350-20-35-42 and 43 describe two approaches a reporting entity may follow when assigning goodwill. Thes methods are referred to as an acquisition or a "with-and-without" approaches.

Under the with-and-without approach, allocated goodwill is the difference between the fair value of that reporting unit before the acquisition and its fair value after the acquisition represents the amount of goodwill to be assigned to that reporting unit (ASC 350-20-35-43).

Note that conceptually, the difference between the fair value of a reporting unit before and after the acquisition only reflects buyer-specific synergies. Entity-specific synergies and market specific synergies, if any, are included in the fair value of the reporting unit before and after the acquisition. From this perspective, applying the with-and-without method may likely result in understatement of goodwill to be allocated to the reporting unit.

Let us illustrate the above point with example. Company A acquired Company B for $ 1,000. Fair value of Company's B net assets was determined as $ 900. Fair value of net assets was determined excluding buyer-specific (i.e., external) and entity-specific (i.e., internal) synergies, consistent with accounting definition of goodwill. Let's say fair value of byer-specific synergies equals $ 80, entity -specific synergies- $ 20. In this case, fair value of Company B before the acquisition will be $ 920 (i.e., $ 900 + $ 20), after the acquisition- $ 1,000. Fair value after the

acquisition includes both types of synergies associated with Company B. Using with-and-without method would result in allocated goodwill of $ 80 determined as $ 1,000 less $ 920. AT the time same, accounting goodwill equals $100. Note that the above example assumes no market participant synergies, only entity-specific and buyer-specific synergies.

As illustrated above, using with-and-without method may likely result in understatement of goodwill to be allocated to specific reporting unit.

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