THE ROLE OF GOODWILL IN UNDERSTANDING THE FINANCIAL POSITION OF A COMPANY

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ABSTRACT

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ABSTRACT

The background of this study is adoption amendments to the standards of accounting and reporting applicable to goodwill by IASB in 2008. The amendments significantly influenced the modern accounting for goodwill in accordance with standards provided by IASB, as well as led to controversy in the financial world regarding the application of the amendments. The topic for this thesis was provided by audit department of PricewaterhouseCoopers. The problem of this thesis is to define appropriate method for accounting of the goodwill under IASB regulation and what is hidden under this line in some years after the M&A deal.

Qualitative research methods were used in this thesis in the form of text analyses, interpretation and interviews. In order to understand the qualitative component of goodwill, we analyzed the current versions of the applicable standards, as well as previous versions, drafts standards, comment letters to the changes. Also it was decided that it would be useful to know the view of reports users on this line and if possible, its use. We made quantitative analysis in the form of an interviews and survey of people employed in the financial industry and working directly with reports.

Based on the research it can be stated that the current regulation is valid with respect to the accounting of goodwill. Accepted changes satisfy most of the users and perpetrators of the financial reports. We can say that in theory current accounting standards allow user of reports make some conclusions about company financial position, however in practice the value which shown under goodwill line is very subjective and therefore is not very useful. However current regulations may be most appropriate way to subsequent accounting of goodwill.

Keywords IFRS, M&A, Goodwill, Finance.

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ABBREVIATIONS

BS	Balance sheet
P&L	Profit and Loss Statement
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IAS	International accounting standards
M&A	Mergers and acquisitions
RAS	Russian Accounting Standards

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1 INTRODUCTION

1.1 Background

In this paper by goodwill we refer to an accounting goodwill which is regulated by accounting and reporting standards by IASB.

Standardization of M&A deals in accounting was actual even 20 years ago. History of goodwill accounting begins in 1981, when the first standard was in a beginning of the developing process. It was published in 1983 as IAS 22 (1983) “Accounting for Business Combinations” and was adopted in 1985 as an effective date of IAS 22. In 1993 and in 1998 IAS 22 was revised. The Standard covers both the acquisition of one enterprise by another and also situation where the acquirer cannot be identified (IasPlus, 2013).

According to IAS 22 goodwill from the acquisition should be recognised as an asset and amortised over its useful life, which is normally not exceed 20 years. But also the standard indicates that the 20-year maximum presumption can be overcome "in rare cases" — for instance if the goodwill is so clearly related to an identifiable asset or group of identifiable assets that it can reasonably be expected to provide benefits over the entire life of those related assets. Goodwill were normally amortised on a straight-line basis in a period not exceeded 20 years (IasPlus, 2013).

In 2001 an Exposure Draft of Business Combinations was published together with related exposure drafts proposing amendments to IAS 36 and IAS 38. In 2004 IFRS 3 was published and it superseded IAS 22. In 2008 and in 2010 IFRS 3 was revised. Some of most significant changes about goodwill were exclusion of goodwill amortisation and obligation to perform impairment of goodwill annually instead (IasPlus, 2013).

Goodwill in financial accounting has existed already for a long time, but there are still many questions and disputes concerning accounting and the usability of goodwill as a financial report line. The changes which were accepted in 2008 in the standards of IASB caused still a big wave of indignation both from the accountants and auditors.

1.2 Commissioning organization

PricewaterhouseCoopers (or PwC) is a multinational network of companies offering professional services in the field of consulting and auditing, headquartered in London, United Kingdom. Under “Pricewaterhouse-Coopers” are companies included in to the global network of companies PricewaterhouseCoopers International Limited, each of which is a separate legal entity (PwC Global, 2013). The company has existed for over 160 years and is part of the so-called Big Four audit firms (Pricewaterhouse-Coopers, Ernst & Young, KPMG, and Deloitte). Pwc is the world's second-largest professional services firm measured by revenues in 2012. (Reuters, 2012)

This thesis project was commissioned by the Russian audit department of PwC.

1.3 Research question, objectives and methods

The main research question was:
What is the most appropriate method of accounting for an excess of consideration transferred to controlling shareholders over the fair value of net assets acquired company under IFRS?

It was decided to breakdown the main question into to smaller parts which are listed below:

- What goodwill really mean as an asset?
- By its nature, is goodwill an asset or an expense?
- Which method of goodwill subsequent accounting is more correctly reflects the nature of the subject?
- Can investors or readers of reports use goodwill under current regulations?

In order to answer the questions above, together with company supervisor a list of objectives was designed for this research, as presented below:

- Analysing of reporting and accounting standards provided by IASB
- Analysis of comment letters and exposure drafts of standards applied
- Analysis of the users, and perpetrators, opinion on goodwill accounting

Qualitative research methods were used in this thesis in the form of narrative analysis, interviews and a survey. The materials in the theory part of this thesis are a summary of goodwill regulations under current standards. The practical part contains an analysis and a critique of current standard, an analysis of investors and experts opinions about goodwill accounting as well as a survey on goodwill accounting and its usability.

1.4 Structure of thesis

The thesis consists of two main parts: the theoretical and practical. The theoretical part helps the reader without any specific knowledge to go through the most useful information for understanding the analyses done in the practical part. There are the basic M&A principles, and accounting and reporting standards applied to goodwill presented.

2 THEORY PART

As a financial line item Goodwill is strongly controlled by the accounting and reporting standards. In this chapter relevant accounting standards definitions and regulation in relation to goodwill are dealt with. It will give us clear understanding of goodwill as a quantities measure, and it will help to consider the topic of this thesis from the content part of the goodwill.

2.1 Accounting standards applicable

Goodwill can often arise when one company is purchased by another company or in M&A deals, which are controlled under IFRS 3 “Business Combinations”. Goodwill is also an intangible asset, so it is also controlled by IAS 38 “Intangible Assets”.

In this chapter a M&A is at first described as a process or event of goodwill rise and it first recognition under IFRS, subsequent accounting and reporting.

Bookkeeping as one of the components of accountancy is simply the recording of financial transactions. All transactions including purchases, sales, receipts and payments should be registered and shown in reports. So how should bookkeepers and accountants show an M&A deal in the report of purchaser or the “parent” company? We already know that the purchasing prise is likely to exceed the fair value of assets and liabilities of the company. We can say that all the assets and liabilities of the daughter company will be allocated to the assets and liabilities of the parent company. But what should accountants do with the difference between paid price and already allocated assets and liabilities? This is when Goodwill comes to the reports. But should it create a separate asset in a report or should it be written as an uncovered expense? One of the purposes of this research project was to answer this question. Below we will consider regulations of goodwill as well as consider investors opinions on this asset.

2.2 M&A

An M&A process is one of the tools for implementing the strategic plans of the company owners and corporate managers. Rejection from the evolutionary process of development where company always use internal capabilities and resources to the revolutionary process, which is the corporate integration, driven by the need to respond to the changing market environment, development ahead of competitors, the market share, or a need to save the current economic position. The acquisition of competitive advantages in the face of integration with partners, their resources and capabilities, coupled with the potential of the company can contribute effectively in changing market conditions.

The main idea and motivation behind mergers and acquisitions is synergy. Something that will make two companies together generate better profits than the same two companies working separately. The companies plan to gain a greater market share or to achieve greater cost efficiency. Or sometimes it is a compulsory measure to survive on the market. Rules work both for merger when companies come together to become stronger and for acquisitions when one business takes a control of another business (Moeller & Brad, 2011).

The M&A market is huge, according to Thomson Reuters. Only in 2012 there were 28 449 deals made for USD 2 040 637 300 000 and the monetary amount is actually decreased by 16% compared to the 2011 values can be seen in the picture below.

Scorecard: Worldwide Completed M&A — **Jan 1 - Dec 31**

Target Region/Nation	1/1/2012 -12/31/2012 Rank Val US$m	1/1/2012 -12/31/2012 No. Deals	1/1/2011 - 12/31/2011 Rank Val US$m	1/1/2011 - 12/31/2011 No. Deals	% Change in Rank Value
Worldwide	**2,040,637.3**	**28,449**	**2,424,490.4**	**31,849**	**-15.8 ▼**
Americas	1,085,322.3	9,667	1,144,683.7	10,400	-5.2 ▼
Caribbean	4,966.5	86	12,496.0	126	-60.3 ▼
Central America	10,618.8	181	31,033.2	195	-65.8 ▼
Mexico	7,993.2	129	29,885.0	143	-73.3 ▼
North America	984,997.7	8,397	994,672.9	8,934	-1.0 ▼
United States	882,129.9	6,946	898,363.5	7,381	-1.8 ▼
Canada	102,867.8	1,451	96,309.4	1,553	6.8 ▲
South America	84,739.2	1,003	106,481.5	1,145	-20.4 ▼
Brazil	58,210.0	502	72,312.4	490	-19.5 ▼
Chile	11,185.0	146	14,362.0	170	-22.1 ▼
Africa/Middle East	41,994.2	771	37,956.2	728	10.6 ▲
Middle East	13,437.0	333	11,941.8	334	12.5 ▲
North Africa	3,281.9	79	3,460.6	70	-5.2 ▼
Sub-Saharan Africa	14,615.0	320	20,940.5	275	-30.2 ▼
Europe	512,680.6	11,029	748,964.3	13,241	-31.5 ▼
Eastern Europe	68,297.6	2,827	135,108.9	3,809	-49.4 ▼
Western Europe	444,383.0	8,202	613,855.3	9,432	-27.6 ▼
United Kingdom	116,564.8	2,073	123,754.8	2,207	-5.8 ▼
Spain	59,529.3	657	68,004.7	821	-12.5 ▼
Germany	50,567.4	1,118	53,785.9	1,313	-6.0 ▼
Asia-Pacific	297,582.8	5,479	402,160.6	6,162	-26.0 ▼
Australasia	78,000.8	1,224	135,788.2	1,229	-42.6 ▼
Australia	72,563.5	1,088	129,046.1	1,087	-43.8 ▼
New Zealand	5,209.9	119	6,383.7	132	-18.4 ▼
South East Asia	52,280.0	1,189	61,774.2	1,582	-15.4 ▼
Malaysia	21,278.4	350	14,392.7	429	47.8 ▲
Singapore	17,366.5	249	15,859.4	300	9.5 ▲
North Asia	154,336.6	2,410	167,850.3	2,668	-8.1 ▼
China	83,259.3	1,359	98,363.6	1,343	-15.4 ▼
South Korea	46,751.2	756	42,737.0	874	9.4 ▲
South Asia	12,965.4	656	36,748.0	683	-64.7 ▼
Central Asia	10,660.4	39	1,613.3	49	560.8 ▲
Japan	103,057.5	1,503	90,725.7	1,318	13.6 ▲

Table 1 Worldwide completed M&A, Thomson Reuters (2012)

If we compare the data in the table on a picture below, which deals during the last seven years, we can clearly see that the highest number of M&A can be seen during the years 2005-2007 with a maximum volume in 2007 of 46 662 deals for approximately USD 4 070 billions. This clearly shows the effect on the M&A market as well as all others.

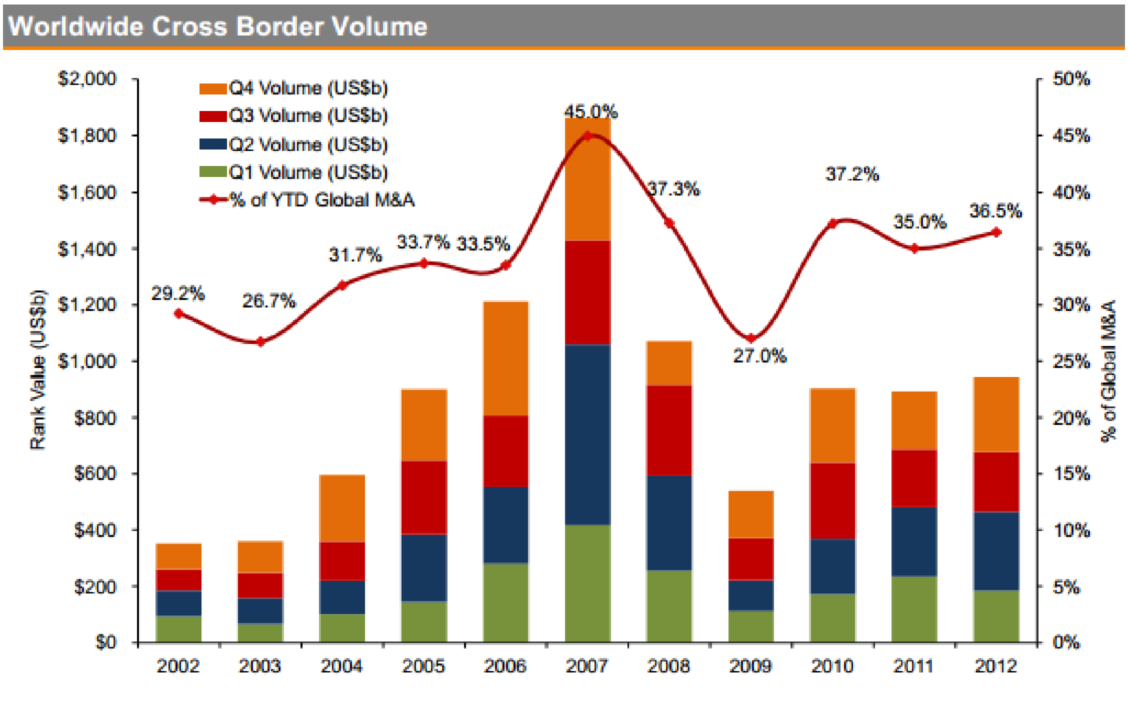


Figure 1 Worldwide cross border volume, (Thomson Reuters, 2012)

According to KPMG "Intangible Assets and Goodwill in the context of Business Combinations" of 2009, the goodwill part in the purchased price fluctuates from 36% to 70.4% depending to industry, from Energy and Power generation to Internet commerce respectively. This difference can be easily explained industry specifics such as the need for huge and expensive tangible assets such as property plants and equipment. Such assets decrease the goodwill amount in the purchase price at the same time when reputation and market share, which theoretically represent goodwill, are keys of a success for e-commerce.

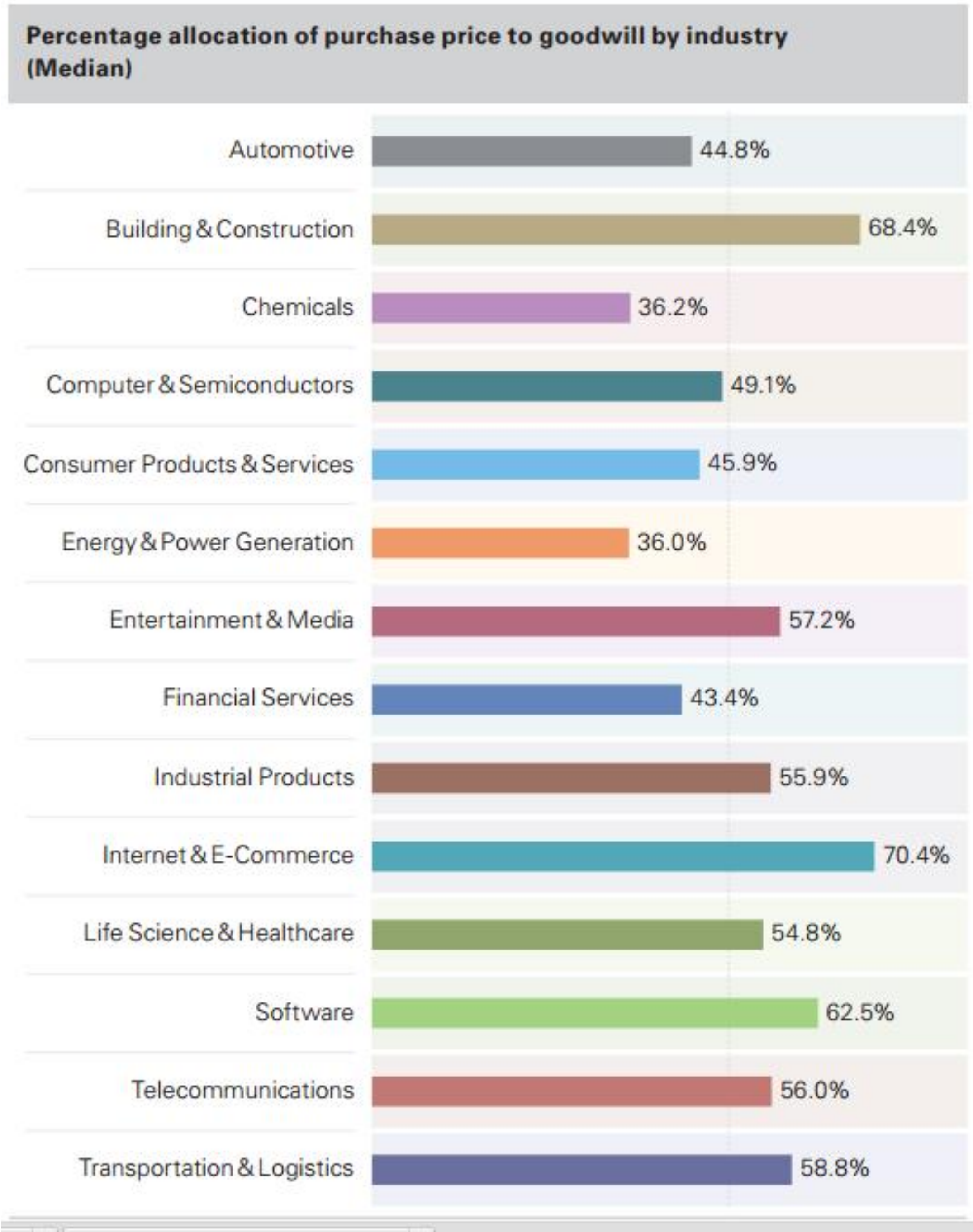


Figure 2 Percentage allocation of goodwill by industry, KPMG (2009)

If we consolidate all the numbers on the figure above, we can make a crude assumption that goodwill figure in mergers and acquisitions in 2012 was somewhere between USD 734629,428 m (USD 2040637,3 m * 36%) and USD 1436608,6592 (USD 2040637,3 m * 70,4%). These numbers are significant which means that the level of materiality in goodwill financial statement line is high and the relevance of this research is high as well.

2.3 Variance of M&A

If we will watch to the business combinations from the structure point of view we can divide all M&A deals by several groups (John Wiley & Sons, 2011):

- Horizontal – is a merge of companies which are in direct competition and share the same product lines and markets. The main goal of such merge is to get better market share or to come together to be more competitive
- Vertical – is a merge of customer and company or a supplier and company, basically. The main goal is to reduce costs for raw materials and to enhance stability of the materials delivery
- Market-extension - Merge of companies that sell the same products in different markets to improve market positions and revenue
- Product-extension– Merge of companies selling different but related products in the same market.
- Conglomeration - companies that have no common business areas.

Almost all kinds of mergers have similar motives, like cost reduction or earnings growth and this can be achieved through methods below:

- Increase the liquidity of shares
- Speculative motive
- Selfish motives of managers
- Motive monopoly
- Access to large contracts
- Reduction in the cost of credit
- Centralization of functions
- Access to information
- Access to new markets
- Eliminating inefficiencies
- Centralization of functions

We can clearly see that M&A is powerful tool in hands of corporate managers and should improve market positions of the company as well a financial position however it is not always so. There was a lot of deals made which was not justified the investment which was calculated from the expectations from synergy.

The cause of the opposite effect can be high expectations on the scale of synergies. An example of such a transaction is the acquisition of Columbia Pictures by Sony. The transaction was made in order to increase sales of Sony VCRs format Betamax. Sony, which released this format of VCR faced with poor promotion of the product on the market in the face of strong competition with major producer of VCR format VHS – Matsushita Corporation. Sony has seen the solution of the problem with the promotion of his VCR in production of items playing on this equipment. On a way to solve this problem, Sony has chosen acquisition of Columbia Pictures, which cost it $6 billion in 1989. After replacing of studio management and actually losing the control over studio activities, Sony did not get the expected synergies from revenue growth, and reported losses of the Columbia Pictures in the amount of $3.2 billion. Why they did not get the expected synergies? In this case, the reason of failure was different vision of business development of Sony and other manufacturers of audio and video players. Sony's failed to achieve wide distribution of its digital audio tapes and minidisc formats in the U.S. and worldwide (Sydney Finkelstein 2004).

2.4 Scope of IFRS 3

The main principle is: An acquirer of a business recognises the assets acquired and liabilities assumed at their acquisition-date fair values and discloses information that enables users to evaluate the nature and financial effects of the acquisition.

The objective of IFRS 3 is to improve the relevance, reliability and comparability of information about a business combination and especially of its effects, which will be shown in the financial report of an entity. To achieve this goal, this IFRS establishes principles and requirements for the buyer:

- Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquire
- Recognizes and measures the goodwill acquired in the business combination or the proceeds of a bargain purchase
- Determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of the business combination.

The key matters of goodwill are as follows:

- Initial recognition and evaluation
- Subsequent evaluation, which can be reduced mainly to impairment
- The disclosure of the information in the financial statements.

Definition of a business combination according to IFRS 3 “A business combination” is a transaction or event in which an acquirer obtains control of one or more businesses. A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to investors or other owners, members or participants. (IFRS 3, Appendix A)

Entities shall apply IFRS 3 when accounting for business combinations. However, IFRS 3 does not apply to combinations (IFRS 3.2):

- involving the formation of a joint venture
- involving entities or businesses under common control
- involving the acquisition of an asset or a group of assets that does not constitute a business

Other words only those deals are counted which are between two independent businesses, which are involving buying of business as a complex but not a separate assets.

2.5 Goodwill

Typically, the amount paid for the business in a business combination or M&A deal does not match with the sum of the net assets acquired, so there is a difference which can be recognised as an overpayment or a discount from price.

The task of accounting is to explain the origin of this difference, to break it into components. For this purpose should be performed revaluation of net assets at fair value on the effective date, because if we will compare amounts which represent a market evaluation and an book value of net assets is a violation of the IFRS principles of comparability. In addition, we have to identify intangible assets such as own brands, domains on the Internet, customer lists, etc. that are not taken into account in the balance sheet of target company at the acquisition date but have a fair value. Finally, IFRS 3 requires the recognition of a business combination contingent liabilities which are also clarify the evaluation of goodwill.

After the identification of the components arising from business combinations differences remain an irreducible amount, which will be the goodwill. In accordance with IFRS 3 goodwill - is the future economic benefits arising from assets that cannot be individually identified and separately recognized.

In accordance with IFRS 3 at the date of purchase the buyer should:
- recognize goodwill acquired in a business combination as an asset
- evaluate goodwill at cost

The actual value of goodwill is determined as the difference between the amount paid and the fair value of the identifiable assets and liabilities, including contingent liabilities, and may be represented by a formula:

$$G = a - b$$

Where G is goodwill, a and b are the content of paragraphs (a) and paragraph (b) below (IFRS 3.32):

a) the aggregate of :
   - the acquisition-date fair value of the consideration transferred
   - the amount of any NCI (non-controlling interest) in the acquired company
   - in a business combination achieved in stages the acquisition-date fair value of the acquirer's previously-held equity interest in the acquired company

b) Net assets or a the difference between of the identifiable assets acquired and liabilities assumed at the acquisition date

Combining written above we can write Goodwill as follows:

$$G = P + NCI + PHI - Net\ assets$$

Where

G - Goodwill;
P - Purchase price;
NCI - non controlling interest in the target company;
PHI - previously held interest in the target company;
Net assets - net assets of target company.

This formula is different from the more familiar one:

$$G = P - Net\ assets$$

And the reason is that IFRS formula includes situations when a business combination achieved in stages by adding to P the PHI, and the logic is that in the end of multi staged acquisition, final price of the acquisition is:

$$P_{deal} = P_1 + P_2 + \cdots + P_n$$

Where P_1, P_2 … P_N is a Prices of N previous purchases of interests in the target company.

The interesting part that now IFRS 3 allows an accounting policy choice, available on a transaction by transaction basis, to measure NCI either at:

- fair value (sometimes called the full goodwill method), or
- the NCI's proportionate share of net assets of the acquiree (option is available on a transaction by transaction basis)

The full method is quite new addition for the IFRS 3 in edition of 2008. Basically this addition allows companies to show in their consolidated reports goodwill of purchased company in a full amount even in the situations where they have only 51% of company shares instead of showing 51% of the goodwill. The logic of such method is in the idea that when some company shows assets of its subsidiaries, head company shows the assets in full amount, and only cash flows such as revenue are shown in proportional value. Before 2008 companies were showing goodwill in in amounts proportionate share of ownership. Below we will calculate goodwill of the same deal but with these two different methods.

Example:
Company “A” purchased 90% or 900 shares in a capital of company “B”, the net assets of “B” at the deal date was equal to $20000. Market price of “B” shares was $30 per share.

The goodwill calculation by full method will be as follows:

$$G = 900\ shares * \$30 + 100\ shares * \$3 - \$20000$$
$$= \$30000 - \$20000 = \$10000$$

Calculation of the method of partial goodwill would calculate goodwill for the same deal as follows:

$$G = 900\ shares * \$30 - (100\% - 10\%) * \$20000$$
$$= \$27000 - \$18000 = \$9000$$

The difference between this two methods is very significant if we will take in to example real deals where the numbers are much higher.

Assuming written above, the value of the goodwill in a financial report is determined by calculation and depends on the following variables:

- purchase price or the cost of the business combination
- the fair value of the net assets, including
  - assets (other than intangible)
  - liabilities (excluding contingent)
  - identifiable intangible assets
  - contingent liabilities
- NCI (for some deals and some accounting policies)

We will consider the calculation procedure of each significant of the components above of the goodwill valuation in accordance with IFRS 3 in next chapters.

2.6 Badwill (Negative Goodwill)

If the acquirer's share of the fair value of the net identifiable assets over the price of a business combination accounted for there is a negative difference, which is treated as follows (IFRS 3.34):

- An assessment of the identifiable assets and liabilities of the acquired company and the estimated cost of the business combination
- The remaining amount is recognized immediately in the P&L accounts as a gain

However, the income that is recognized in this case would not be real. It cannot serve as a source of payment of any dividend to the shareholders, not the actual tax base for income tax.

Example:
Company “Matti and Petri” acquires “Abc partners” for 50 m euro. Fair value of net assets is 60 m euros. The difference is negative goodwill - 10 m, which is recognized as other income in the profit and loss account for the buyer.

2.7 Purchase price

According to the previous version of IFRS 3 purchaser had to determine the purchase price as the aggregate amount of the fair value of the net assets of the acquired company at the date of exchange, and any costs directly associated with the merge, such as the cost of professional services of accountants, consultants, lawyers, appraisers and other experts.

Current version of IFRS define accounting of acquisition costs as follows: Costs of issuing debt or equity instruments are accounted for under IAS 32 and IAS 39. All other costs associated with the acquisition must be expensed, including reimbursements to the acquiree for bearing some of the acquisition costs. Examples of costs to be expensed include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; and general administrative costs, including the costs of maintaining an internal acquisitions department.(IAS Plus, 2013)

Another words we can assume that current standard states that the transaction costs are not part of compensation paid seller of a business. These costs also are not assets of the acquired business, which are recognized on acquisition. Transaction costs should be accounted as expense in relevant period. The standard requires the disclosure of the amount of transaction costs in the P&L report. Same rule applies to general administrative costs, costs of organizing the issuance of financial liabilities, the cost of issuing equity instruments, the future losses and expenses anticipated in connection with the business combination.

Example:
Company “Matti and Petri” acquires “Donald and Mickey” for 100 m euro and pay extra expense of 5 m euro for legal services and 1 m to consultants for due diligence. General and administrative expenses accounted for 4 m euro.
In that case aggregated purchase price will be equal to 100 m euro and that amount will go from the cash account to the investments account in the report of “Matti and Petri”, other expenses of 10 m will be recognized as an expense in the profit and loss report.

2.8 Fair value of identifiable net assets

Net assets part of Goodwill equation consists of assets and liabilities which, according to IFRS 3, shall be measured at their fair value at the acquisition date. Here we will consider what the fair value according to IFRS is.

Measure at the fair value means that we have to apply IFRS 13 which states that to determine the fair value of certain assets and liabilities of the buyer, we should use:

- For financial instruments traded in an active market - current market prices
- For financial instruments not traded in an active market - estimated value, which takes into account such factors as the price-earnings ratios, dividend yields and expected growth rates of comparable instruments of companies with similar characteristics
- For receivables and other identifiable assets - the discounted value as determined by the current interest rates, net of bad debts and the cost of collection. Discounting is not required for short-term receivables and other short-term identifiable assets, unless the effect of discounting is not significant
- Recourses:
    - For finished goods - sales prices minus the amount of selling costs and a reasonable profit margin
    - For WIP (work in progress) - the sales prices for finished goods less the costs of completion of production, sales expenses and a reasonable rate of return

    - For raw materials - the current value of purchase of similar raw materials
- For land and buildings - market value
- For machinery and equipment - market value
- For intangible assets - based on prices in an active market in accordance with IAS 38 "Intangible Assets", or, if an active market does not exist, based on the costs that the buyer would pay for intangible assets in a transaction with an independent
- For pension plan assets or liabilities with defined benefit - the current value of the fixed employee benefit obligations less the fair value of plan assets
- For tax assets and liabilities - the amount of tax benefits recognized in the perspective of taxation of the combined company. (IAS 12, 2010)
- For accounts payable, notes payable, long-term liabilities, advances from customers and other requirements - the present value of the obligations set using appropriate current interest rates. Discounting is not required for short-term obligations, unless the effect of discounting is not significant (same rule as with Receivables)
- For contingent liabilities - the amounts that would have requested a third party for taking on these contingent liabilities

2.9 Identifiable intangible assets

In accordance with the rules of IAS 38 for the recognition of an intangible asset only if it met the definition of an object as a non-monetary asset that can be identified, in other words, separate from other assets or derived from contractual or other legal relations.

Under those criteria we can account:

- computer software
- patents
- copyrights
- motion picture films
- customer lists
- mortgage servicing rights
- licenses
- import quotas
- franchises
- customer and supplier relationships
- marketing rights
- other items similar in substance that had not previously been recognized as an intangible asset and treated as components of internally generated goodwill.

Good to mention here that, for author opinion, the internal goodwill does not meet the criteria for recognition in the financial statements as intangible asset because it has no reliable and accurate valuation. In accordance with IFRS recognition occurs when:

- it is likely that any economic benefit associated with it is received or lost by the company.
- object has a valuation that can be measured reliably

Such rules of intangible assets recognition may be associated with the desire to maximize identify the assets acquired and liabilities and to reduce to a minimum the amount recognized as goodwill.

Example:
Now “Matti and Petri” now acquires “Ski Ski and Co” for 150 m euro, but before the deal “Ski Ski and Co” entered into a long-term contract for the supply of goods to the buyer “X-riders”. Fair value of the contract is 20 m euro, other assets of 100 m and liabilities of 30 m.
Goodwill = 150 – (100-30+20) = 60 m euro.

2.10 Subsequent Accounting for Goodwill

In accordance with IFRS 3, after initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is not amortized but is tested for impairment in accordance with IFRS (IAS) 36, "Impairment of Assets" every year (regardless of the presence of impairment), or more often (if there is evidence of impairment).

Testing goodwill for impairment involves comparing the recoverable amount of purchased goodwill with book value.

The recoverable amount - is the higher of fair value less costs of disposal and value in use.

Fair value - the amount that can be obtained from the sale of an asset in a transaction between informed, mutually independent parties.

Value in use – value which equals to NPV if all expected future cash flows raise from the use and disposal of that asset.

However, it is obvious that testing for goodwill impairment on an individual basis (determination of the recoverable amount of goodwill itself) is impossible, because we cannot separate goodwill from other. To resolve this issue IAS 36 introduces the cash-generating unit and testing of goodwill is based on this CGUs.

Example:
Group of companies "A holding" acquires "B", which is a competitor of one of the existing businesses of the acquirer. Company "B" will be closed, and its customers will be taken by companies of the "A holding". Goodwill, which belongs to the company “B” should be allocated to the CGU (group of CGUs) of the existing businesses of the "A holding" because they will get the customers and as a result, benefits from the acquisition of "B".

Cash Generating Unit (CGU) is the smallest group of assets that by its use generates cash inflows independent of the cash inflows from other assets or groups of assets. For example, a single automation machine in the factory cannot generate final product and obviously cash flow without entire production line. However CGU cannot be larger than an operating segment determined in accordance with IFRS 8 (Operating Segments).

For the purpose of impairment testing, goodwill acquired in a business combination shall be allocated with cash generating units which get the benefit from the purchase.

Acquired goodwill is a kind of a charge which company pays in anticipation of future economic benefits from assets which not possible to identify and recognize separately. In other words, goodwill does not generate cash flows independently of other assets but often should has a positive effect on cash flows from other several units. That is why the recoverable amount of goodwill as an individual asset cannot be determined. And if there is evidence of probable impairment of goodwill will not be determined specifically its recoverable amount and the recoverable amount of the entire cash-generating unit to which the goodwill relates.

That is why the recoverable amount of goodwill as an individual asset cannot be determined. And if there is evidence of probable impairment of goodwill will not be determined specifically its recoverable amount and the recoverable amount of the entire cash-generating unit to which the goodwill relates.

Testing involves the steps shown below:

Step 1. Allocate goodwill parts and CGUs

Step 2. Compare the recoverable amount of the unit and its carrying value.

Step 3. If the recoverable amount of the unit exceeds its carrying value, then no further action is required, since the fact of impairment of goodwill during the period was not found.

Step 4. If the carrying value exceeds the recoverable amount then the company must account an impairment loss.

If the carrying amount of the unit is greater than the estimated recoverable value, the company must recognize an impairment loss. Impairment loss reduces the profit for the period.

Impairment loss should reduce the carrying value of the assets of the company in the following order:

1. decreases the carrying value goodwill allocated to that unit;
2. decreases in proportion proportionally the carrying value of assets included in CGU

However, after the allocation of the impairment loss carrying value of the asset should not be lower than the highest value of the three indicators:

– its fair value less costs of disposal (if measurable)
– its value in use (if measurable)
– zero

Assuming written above we can picture the process in the diagram below:

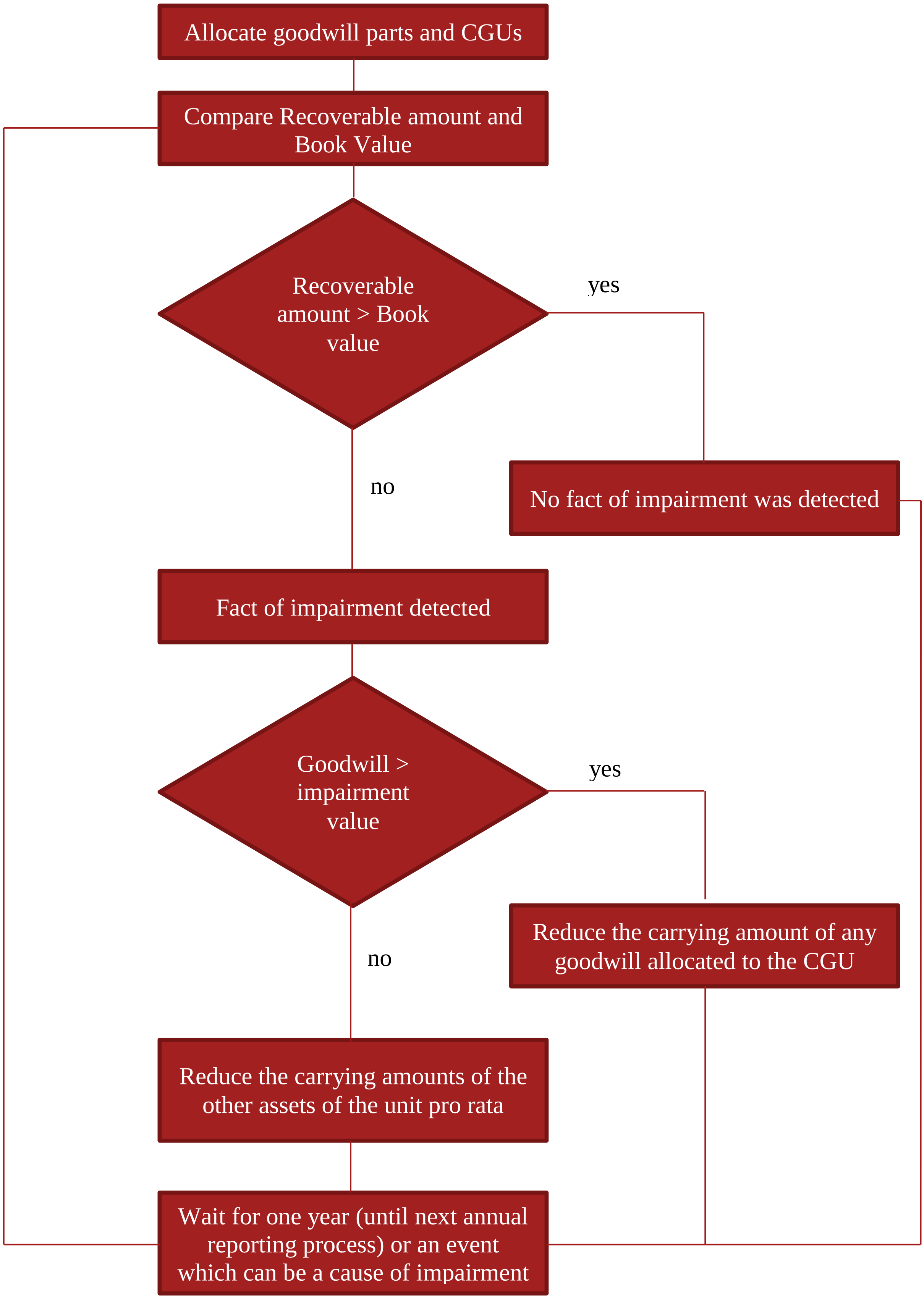


Figure 3 Goodwill impairment test process

We can clearly see that enterprises should not have freedom of choice in allocating goodwill to reporting units. Under IFRS, this classification must be "reasonable and acceptable." If goodwill is attributed to the weak unit, then it may have to write off immediately or very soon, and any goodwill allocated to the unit highly profitable, has all chances to be never written off.

Company “Abc” acquired company “D”. Acquired goodwill equals EUR 3000 and was assigned to two generating units - transport and marketing segments in a ratio of 1200:1800.
A year later, the company “Abc” tested for impairment the generating units in the transportation business, and got the following results: the recoverable amount of CGUs equal to EUR 15000. And the carrying value of CGUs is 17000 euro, including the carrying value of the assets:

- tangible assets – EUR 7000
- intangible assets – EUR 7000
- receivables – EUR 3000

We define the impairment loss; all estimates are presented in Table 3 below.

Asset	**Beginning of a period**	**Impairment**	**End of a period**
Goodwill	1800	1800	
Tangible assets	7000	82,3	6917,6
Intangible assets	7000	82,3	6917,6
Receivables	3000	35,4	2964,7
Total	**18800**	**2000**	**16800**

Table 2 Allocation of impairment

a) Impairment = 1700-1500 = 2000
b) Impairment of Goodwill - 1800
c) Impairment of other assets = 2000-1800 = 200
d) Impairment of Tangibles = 200*(7000/17000)=200*41%=82,3
e) Impairment of Intangibles = 200*(7000/17000)=200*41%=82,3
f) Impairment of Receivables = 200*(3000/17000)=200*18%=35,4
g) End of period Tangibles = 7000 – D =6917,6
h) End of period Intangibles= 7000 – E =6917,6
i) End of period Receivables = 3000- F = 2964,7

2.11 Reversal of impairment loss

If in the following years after the impairment loss was recognized there has been significant growth in goodwill (related to the increase in the value of the company name, the development of the customer base and other factors that are able to generate profit), then this is an indication that an impairment loss recognized in prior years, decreased or no longer exists.

However, international financial reporting standards do not allow the reversal of goodwill impairment, as any subsequent increase in recoverable amount of goodwill will be an increase in internally generated goodwill within the company. And internally generated goodwill does not qualify for recognition in the financial statements.

Example:
At the next reporting date company “Abc” from previous example got information that impairment loss calculated in the previous example is recovered. The recoverable amount of the units determined as of that date in the amount of EUR 20 000. Corresponding estimates are shown in Table below.

Asset	**Beginning of a period**	**Impairment reverse**	**End of a period**
Goodwill	-		
Tangible assets	6917,6	82,3	7000
Intangible assets	6917,6	82,3	7000
Receivables	2964,7	35,4	3000
Total	**16800**	**200**	**17000**

Table 3 Allocation of reversal of impairment

The difference of 3000 is not shown in the end of the period because it belongs to goodwill

2.12 Disclosure

These financial statements have to be disclosed information that will give users the opportunity to assess the dynamics of reporting carrying amount of goodwill during the period, namely (IFRS 3.59):

- about the factors that influenced the increase in the value of goodwill when taking it to the account, i.e. a description of each intangible asset that was not recognized separately from goodwill and an explanation of why fair value of the asset cannot be measured reliably
- about value of goodwill and accumulated impairment losses from it
- about goodwill included in a group of assets held for disposal
- about impairment losses recognized during the reporting period
- on the amounts recognized in the income statement as negative goodwill

3 PRACTICAL PART

3.1 Analysis of regulations and official comments

3.1.1 Analysis of IFRS applied

In this part we will go through the IFRS 3 “Business combinations” as well as through IAS 36 "Impairment of Assets", with comments according to usage of the Goodwill as a tool to understand company financial situation.

Observation of the regulations presented in the theoretical part of this research made some confusion which author would like to mention:

- Goodwill is an asset but cannot be identified alone or be divided from CGU
- Goodwill is not decreasing with income cash flows, but recalculating

3.1.1.1. Initial recognition

Chapter 2 makes it clear to us that goodwill is a difference between purchased price and net assets of the company acquired. In the same time standard says that Goodwill acquired in a business combination represents a payment made by the acquirer in anticipation of future economic benefits from assets that cannot be individually identified and separately recognized

Let us consider goodwill definition by famous experts:
Goodwill (the firm's reputation) - is an intangible asset that is not reflected in the balance sheet. Its structure is formed elements such as new technology, advanced products, the share of the gains from the merger, etc. (Brealey, Myers. 2007).

Assuming experts and IASB definition we can say that Goodwill is a monetary value of reputation of the company, including an assessment of a brand by clients, management, employers and other factors which can gain profits to the company. Also we can make an assumption that goodwill- is a sum all future cash flows expected by buyers in M&A deal.

But is that enough to consider goodwill as an asset?
According to IFRS framework Asset is:

- A resource controlled by the entity
- As a result of past event
- From which future economic benefits are expected to flow the entity

Author is not sure that we can strongly claim that goodwill as a value controlled by the company. To keep goodwill value on the same rate company have to make sure that its market positions and income cash flows are growing or at least on the same level, but in the current situation when we have very competitive markets this objective looks not fully controlled only by the company. With other asset characteristics we can agree, but let us consider intangible asset definition below.

Goodwill shown in the financial report as an intangible asset, it seems reasonable to consider IFRS definition of intangible asset below.

According to IAS 38, intangible asset is an identifiable non-monetary asset without physical substance. An asset is a resource that is controlled by the entity as a result of past events (for example, purchase or self-creation) and from which future economic benefits (inflows of cash or other assets) are expected.

Thus, the three critical attributes of an intangible asset are:
- identifiability
- control (power to obtain benefits from the asset)
- future economic benefits (such as revenues or reduced future costs)

So here we have the same with tangible asset definition but the additions that it should be non-monetary and identifiable. According to IAS 38 an intangible asset is identifiable when it:
- is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract) or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

We would like to mention that on the author's opinion goodwill does not satisfy both of the criteria of the intangible asset. By the definition goodwill cannot be separated from the other assets and sold. As well as there is no clear legal rights for goodwill, for example if we say that goodwill represented by employers or manager then we have no rights to keep this people, they can leave or change company when they want, another words we are not controlling them or goodwill generated by them.

The idea is that can we really account goodwill as other assets such as PPE, AR, or brands, licences etc, which can be sold out and bring money to the entity in a cash form immediately or at least soon.

As an example let us assume that company Abc acquired company Def for EUR 15 000. Net assets value of Def is EUR 5000. Now we can consider simplified balance sheet of Abc before and after the deal:

	Before	After
Cash	15000	0
Other assets	0	5000
Goodwill	0	10000
Total assets	**15000**	**15000**

Table 4 Allocation of assets before and after the deal

We can see that before and after the deal total assets or book value (for our example) is the same and equals to 15000. But it is clear that if we will consider a pessimistic turn of events, when you Abc has to stop its activities, investors will get the rights to money from the sale of assets, assets will be sold piecemeal, and therefore no goodwill will be sold. Consequently, investors will receive no share of 15,000, but only 5,000 physical assets (those which we can sell).

Some users of the financial report can deceive themselves thinking that in the case of bankruptcy, they can expect reasonable fraction of the sale of all assets including goodwill. So far, on author opinion, financial statements will be more reliable if goodwill will be accounted as an expense.

Concluding written above we can bring the issue for an analysis:

- Is the current version of IFRS 3 in terms of initial recognition of Goodwill accurately reflects mathematical essence of goodwill?
- If the Goodwill will be accounted as an expense instead of asset, the Balance sheet will reflect more reliable information about company financial situation?

3.1.1.2. Subsequent accounting

In Part 2.8 has been described by the current method of accounting for goodwill, which is to test it for impairment.

If we will look more deeply to the history of goodwill accounting we can see that for many years, the most common form of subsequent accounting of goodwill at the world level was depreciation. However, this method has been the subject of constant criticism, which was based mainly on two major arguments - the complexity and subjectivity in determining the choice of method of depreciation and amortization. The value of the goodwill amortization period ranges from 5 to 40 years or more. In Russian goodwill amortization period can take the value of 20 or more years in the United States for a long time, up to 2001, this period was 40 years.

Another problem with depreciation was connected with tax management. As depreciation is tax deductible, some managers can use it in purposes of tax decreasing programs.

Challenges in determining this value a hard because goodwill represents future economic benefits from synergies that of assets which can be seen only in the interaction. Only in the event that the goodwill related to the identifiable asset, we can be reasonably assume that it will bring profit to the buyer for a period equal to the period of use of the asset. However, it is very complicated to associate goodwill with one particular asset, and with a group of closely related assets, but current method of goodwill accounting requires associating it with assets.

In theory, the as a solution of the previous method can only be a periodic re-evaluation, but on the opinion of author it is not so clear in practice, so there is several points author would like to consider:

- Correctness of the re-evaluation concept
- Correctness of the CGU concept
- Complexity as a source for errors

First of all, author would like to understand is the current method is really capture the essence of goodwill not like a business reputation but as a difference between purchased rice and value of net assets.

In chapter 2.3 we considered how the initial accounting for goodwill goes and understood that it depends on two main variables:

- Purchased price
- Net assets value (NAV)

- Also we consider those two values in chapters 2.5 and 2.6, assuming which we can make a conclusion that NAV is strongly controlled by IFRS, because NAV consists of Assets and Liabilities estimation of which is regulated. Here we can assume that if NAV is strongly regulated and is not variable. And this we cannot say about purchased price which depends on:
- Economical expectations of acquire from the deal
- Negotiation skills of deal makers
- Other non-measurable factors

From factors mentioned above we can measure only economical expectations of acquire from the deal. The purposes of the deal which was presented in the chapter 1.3 can be different, but usually it can be expressed in the form of future cash flows. Another words purchased price which acquire ready to pay was calculated from complex forms of DCF models.

Let us consider classical formula of present value of future cash flows (DCF model):

$$PV = \frac{C}{(1+r)^n}$$

or

$$PV = \sum_{i=1}^{n} \frac{CF_i}{(1+r)^i}$$

Where
PV- Present Value
CF – Cash flow from deal in a time period
r - Interest rate for one compounding period
n- Years of purchase.

So if we say that purchase price in a M&A deal it is present value of all future cash flows which are expected by deal makers in one way or another, we can write in in a form

$$Purchase\ price = \sum_{i=1}^{n} \frac{CF_i}{(1+r)^i}$$

And Goodwill purchased will be calculated as follows:

$$\sum_{i=1}^{n} \frac{CF_i}{(1+r)^i} - Net\ Assets\ Value$$

Here we can assume all written above in this chapter that goodwill mainly driven by purchased price which is represent present value of all future cash flows expected from the deal, or goodwill is driven or represented by present value of all cash flows from the deal.

But our statement creates a conflict with the current situation of accounting of goodwill of future values. To explain the idea let's consider an example:

Repeating a case from the previous chapter, we have a company Abc, which acquired company Def for EUR 15 00. Abc expected cash flows from the deal for 10 coming years as below:

Year	+1	+2	+3	+4	+5	+6	+7	+8	+9	+10
Income CF (EUR)	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000

Table 5 Discounted cash flows of example company.

After 10 years of purchased business usage, Abc will sell assets of the Def
To simplify calculations we imply that interest rate is zero.
NAV of Def is 5000.
Assuming that the deal was made in 2014, we can say that Abc shows on the balance in a year 2014 (values in EUR):
Cash: -15000 (payment for the deal)
Assets: +5000 (net assets purchased)
Goodwill: +10000 (difference between money paid and NAV)
let us consider what will be shown in a simplified financial statement of the Abc in considered periods with different versions of subsequent accounting of goodwill in the table below (all figures are in thousands).

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
P&L													
Income CF	0	-15	1	1	1	1	1	1	1	1	1	1	5
Balance													
Cash	15	0	1	2	3	4	5	6	7	8	9	10	15
Goodwill	0	10	9	8	7	6	5	4	3	2	1	0	0
Other Assets	0	5	5	5	5	5	5	5	5	5	5	5	0
Total	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**

Table 6 Amortisation of goodwill under IFRS 3 (before 2008 revision).

Comments: We can see that purchased goodwill is decreasing according to it planned time of use by equal parts. And balance value is kept at the same level in all periods.

Now let us consider same company financial statement but with use of goodwill impairment testing under current version of IFRS 3 (all figures are in thousands).

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
P&L													
Income CF	0	-15	1	1	1	1	1	1	1	1	1	1	5
Balance													
Cash	15	0	1	2	3	4	5	6	7	8	9	10	15
Goodwill	0	10	9	8	7	6	5	4	3	2	1	0	0
Other Assets	0	5	5	5	5	5	5	5	5	5	5	5	0
Total	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**	**15**

Table 7 Impairment of goodwill under IFRS 3 (after 2008 revision).

From the chapter 2.8 of the current thesis we now that if goodwill will be tested for impairment every period it basically mean that it will be checked how much associated with goodwill CGUs or purchased business will generate cash flows. And if we now that in the period from 2019 (after 5 years of use) it can generate only additional 5000 in all future periods, it mean that the NPV is 5000. Same rule works with other years. But that will work only in theory; in practice it is very hard to calculate future cash flows and periods of use. Another words it is hard to be sure that in 2023 it will be last cash flow from Def and companies more likely to be optimistic and expect cash flows in future if present cash flows are coming. In practice financial report will be as follows (all figures are in thousands):

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
P&L													
Income CF	0	-15	1	1	1	1	1	1	1	1	1	1	5
Balance													
Cash	15	0	1	2	3	4	5	6	7	8	9	10	15
Goodwill	0	10	10	10	10	10	10	10	10	10	10	10	0
Other Assets	0	5	5	5	5	5	5	5	5	5	5	5	0
Total	**15**	**15**	**16**	**17**	**18**	**19**	**20**	**21**	**22**	**23**	**24**	**25**	**15**

Table 8 Impairment of goodwill under IFRS 3 (after 2008 revision).

Here we can see the balance is inflated like a bubble until 2024. This is due to the fact that already implicitly recorded in goodwill cash flows are recorded as income once again and fall into the "cash".

This effect occurs because of the complexity of the computation of future cash flows. In preparation for M&A deals it is perhaps one of the most difficult tasks for which often hired professionals, independent consultants, appraisers. Good to mention that such service is relatively expensive. After the transaction, this problem very often falls on the company accountants who were forced to carry out tests for impairment and therefore forecasting future cash flows in a hurry, because the reporting period is always stressful for companies accounting functions. Numbers shown in a table above can be reached if market situation looks favorable for accountant who is performing the impairment testing. But as we can see in 2025 cash flows from purchased business stopped and in the same time accountants will decide that goodwill is impairment. For investors who have to make decisions relying only on financial report it can be a surprise that in one year company book value decreased on 10000 and cash flows stopped.

Concluding we can say that test on impairment is very risky procedure. Risky because very complicated and as a consequence some mistakes can be done, which will reflect balance sheet and investors opinion as well. In this part we can highlight several questions for an analysis:

- Financial report will be more efficient if goodwill be decreased proportional to profits from the related company?
- Financial report will be more efficient if goodwill be decreased in equal parts in a period of use (amortization principle)?

3.1.2 Impact of goodwill impairment on key financial indicators

According to the last chapter concerns, we decided to perform a current method of goodwill accounting on a practical case, but with scenario that goodwill has been impaired in full amount in some of the years. We choose Nokia as a company for analysis. Data was gathered from Nokia financial statements which have been downloaded from official Nokia web page. We have consolidated Nokia' BS and P&L from 2006 to 2012. Effective date of impairment testing method is 2009 and we can see that from the minimized P&L below.

	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Net sales	41 121	51 058	50 710	40 984	42 446	38 659	30 176
Cost of sales	-27 742	-33 781	-33 337	-27 720	-29 629	-27 300	-21 786
Gross profit	13 379	17 277	17 373	13 264	12 817	11 359	8 390
Research and development expenses	-3 897	-5 636	-5 968	-5 909	-5 863	-5 584	-4 782
Selling and marketing expenses	-3 314	-4 379	-4 380	-3 933	-3 877	-3 769	-3 205
Administrative and general expenses	-666	-1 165	-1 284	-1 145	-1 115	-1 085	-959
Impairment of goodwill				**-908**	**-**	**-1090**	**-**
Other income	522	2 312	420	338	476	221	449
Other expenses	-536	-424	-1 195	-510	-368	-1 125	-2 196
Operating Profit or loss	5 488	7 985	4 966	1 197	2 070	-1 073	-2 303
Share of results of associated companies	28	44	6	30	1	-23	-1
Financial income and expenses	207	239	-2	-265	-285	-102	-340
Profit or Loss before tax	5 723	8 268	4 970	962	1 786	-1 198	-2 644
Tax	-1 357	-1 522	-1 081	-702	-443	-290	-1 145
Profit or Loss	**4 366**	**6 746**	**3 889**	**260**	**1 343**	**-1 488**	**-3 789**

Table 9 Nokia consolidated and minimised P&L from 2006 to 2012.

ASSETS	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Non-current assets	4 031	8 305	15 112	12 125	11 978	10 750	9 071
Goodwill	**532**	**1 384**	**6 257**	**5 171**	**5 723**	**4 838**	**4 876**
Current assets	18 586	29 294	24 470	23 613	27 145	25 455	20 878
Total assets	22 617	37 599	39 582	35 738	39 123	36 205	29 949
SHAREHOLDERS' EQUITY AND LIABILITIES							
Total equity	12 060	17 338	16 510	14 749	16 231	13 916	9 447
Non-current liabilities	396	1 285	2 717	5 801	5 352	4 845	5 856
Current liabilities	10 161	18 976	20 355	15 188	17 540	17 444	14 646
Total shareholders' equity and liabilities	**22 617**	**37 599**	**39 582**	**35 738**	**39 123**	**36 205**	**29 949**

Table 10 Nokia consolidated and minimised BS from 2006 to 2012.

Further have been decided to test how will full goodwill impairment influence on a financial statement value. On the table above we calculated financial statement in each year assuming that goodwill has been impaired in exact year, we are considering only years with applicable impairment method.

	2006	2007	2008	2009	2010	2011	2012
Net sales	41 121	51 058	50 710	40 984	42 446	38 659	30 176
Cost of sales	-27 742	-33 781	-33 337	-27 720	-29 629	-27 300	-21 786
Gross profit	13 379	17 277	17 373	13 264	12 817	11 359	8 390
Research and development expenses	-3 897	-5 636	-5 968	-5 909	-5 863	-5 584	-4 782
Selling and marketing expenses	-3 314	-4 379	-4 380	-3 933	-3 877	-3 769	-3 205
Administrative and general expenses	-666	-1 165	-1 284	-1 145	-1 115	-1 085	-959
Impairment of goodwill				**-6 257**	**-5 171**	**-5 723**	**-4 838**
Other income	522	2 312	420	338	476	221	449
Other expenses	-536	-424	-1 195	-510	-368	-1 125	-2 196
Operating Profit or loss	5 488	7 985	4 966	**-4 152**	**-3 101**	**-5 706**	**-7 141**
Share of results of associated companies	28	44	6	30	1	-23	-1
Financial income and expenses	207	239	-2	-265	-285	-102	-340
Profit or Loss before tax	5 723	8 268	4 970	**-4 387**	**-3 385**	**-5 831**	**-7 482**
Tax	-1 357	-1 522	-1 081	-702	-443	-290	-1 145
Profit or Loss	**4 366**	**6 746**	**3 889**	**-5 089**	**-3 828**	**-6 121**	**-8 627**

Table 11 Assumed Nokia' consolidated and minimised P&L from 2006 to 2012 in a bad scenario.

ASSETS	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Non-current assets	4 031	8 305	15 112	**6 954**	**6 255**	**5 912**	**4 195**
Goodwill	532	1 384	6 257				
Current assets	18 586	29 294	24 470	23 613	27 145	25 455	20 878
Total assets	**22 617**	**37 599**	**39 582**	**30 567**	**33 400**	**31 367**	**25 073**
SHAREHOLDERS' EQUITY AND LIABILITIES							
Total equity	12 060	17 338	16 510	**9 578**	**10 508**	**9 078**	**4 571**
Non-current liabilities	396	1 285	2 717	5 801	5 352	4 845	5 856
Current liabilities	10 161	18 976	20 355	15 188	17 540	17 444	14 646
Total shareholders' equity and liabilities	**22 617**	**37 599**	**39 582**	**30 567**	**33 400**	**31 367**	**25 073**

Table 12 Assumed Nokia consolidated and minimised BS from 2006 to 2012 in a bad scenario.

We highlighted with red those figures which will be changed depending on goodwill. We can see from the financial statements with bad for goodwill scenario, that full impairment have turned profit in 2009 and 2010 to loss, as well as critically decreased company equity in all years. Obviously finance department as well as company management are not interested in such scenario, so it looks that they would prefer not to perform impairment of goodwill when it is possible.

As a real example we can consider situation happened with ArcelorMittal, the world's largest steel producer, with headquarters in Luxemburg. In 2012 ArcelorMittal reported $3.2 billion of operating loss and $4.9 billion of operating income in 2011. It was announced that such a big loss in 2012 was mainly driven by $4.3 billion impairment of goodwill. Goodwill was impaired according to the weak macroeconomic conditions and the unfavourable situation of the European market.

Concluding this case analysis we can make an assumption that impairment testing not only objective, but even fraud risky. The purposes of fraud can be showing inflated balances, unwillingness to accept the costs and thereby reduce their bonuses.

However depreciation method is also not clever for fraud. Depreciation has been always connected with tax management. As depreciation is tax deductible, some managers can use it in purposes of tax decreasing programs. Nowadays in there is depreciation method applied in Russian accounting standards for subsequent accounting of goodwill. Differences between RAS and IFRS can be found in Appendix 3.

3.1.3 Analysis of comment letters and exposure drafts

In previous chapter (3.1.1.2) we clarified that depending on depreciation or impairment testing goodwill differ significantly. Also it is not clear which method of initial recognition of goodwill is correct: full, partial, or as an expense. It is hard to decide which methods are correct. Interviews and survey made by author confirm that people from finance professions are different in opinions.

The process of adoption of a standard is very complex and consists of several stages. Moreover, as has been described above, the current Standard is a modification of the previous, which operated until 2008, which was adopted in 2004. After the adoption, IASB usually open for comment the content letters from financial institutions or valuable companies. This is done to identify the opinions of experts and avoid possible errors and inaccuracies.

For the purposes of understanding and solution issues this research may be useful to research comments of financial institutions or valuable companies, as well as exposure drafts of the standards.

3.1.3.1. Comments to initial recognition

There were analysed Proposed amendments to IFRS 3 “Business combinations”(2005) and IAS 27 “Consolidated and Separate Financial Statements”(2005). Analysis of the exposure drafts was very useful for this research. It was found that not all members of IASB were agreed with the changes in the standard concerning goodwill

According to Exposure draft alternative views were occurred five board members were disagree with the use of the full goodwill method. Because on their opinion this method treats goodwill as an asset that can be identified separately and measured at fair value, like any other asset of the subsidiary, and we already have considered before that goodwill is not such asset. Five board members noted that goodwill is different from other assets, because it is a component of the value of the business as a whole, rather than having a separate existence.

The question that has been raised in a previous chapter about the complexity revaluation of goodwill and as a consequence the possibility of errors in the financial statements also was in minds of board members. They write that the process of measuring goodwill is therefore extremely difficult. The residual nature of its measurement means that it captures measurement errors in other assets, and sometimes non-recognition of those assets. Moreover, the total value of the acquired business is an extremely subjective measure, based upon the acquirer's judgement of the potential returns that it will generate. Not only is the total value of the acquired business difficult to measure, but so is the allocation of the goodwill between the parent and the subsidiary.

By the author of this thesis it was researched comment letters on exposure drafts of IFRS 3 and IAS 27 to find disagreement in respect to accounting of goodwill.

By the author there were examined 71 comment letters for Proposed Amendments to IFRS 3 (2005), the list of companies respondents can be found in Appendix 1 of current thesis. Also there were examined 94 comment letters for Proposed Amendments to IAS 27 (2005), the list of companies respondents can be found in Appendix 2.

As IFRS 3 and IAS 27 is a complex standards which include full standardization of the Business combinations and future consolidated reporting, so comments was addressed to large scope of details. However author was aiming to find comments only regarding goodwill accounting.

Some respondents do not fully agree with the concept of full goodwill which was new, because before goodwill was accounted only in a proportional part to parent share in a company (FAR, ICAEW, AXA, IBF, etc.) Many respondents stated that the proposal put too much emphasis on estimating the fair value of the business and that this estimate can be unreliable and very subjective. Idea of the IASB according to the full goodwill was mentioned in the chapter 2.3 of current research, according to the IASB full goodwill method allows to account goodwill as other assets in consolidated report (in full amount). On IASB opinion such correction increases comparability, and usefulness of goodwill. Because on IASB opinion before goodwill was just an accumulation of cost differences at each step. (According to Project summary from Jan 2008). Some of respondents do not agree with idea of goodwill as an asset.

IASB responds to the comments about financial reports users as: “Users will have more comparable, timelier and more helpful information about the contingent consideration arrangements.”

However author of this thesis also disagree with IASB on following points:

- Comparability is a question because now users can not be sure which part of goodwill really belongs to the parent company, especially it is not cleat for big companies with large network of purchased companies
- Timing is also not clear because fair value estimation means significant expenditures of labour.

Concluding comment letters and exposure draft analysis we can assume that there are significant amount of responds that were not agreed with the approach of full goodwill method accounting. Their assumptions are based on the opinion that the current accounting goodwill is complicated, time-consuming, cost, and less useful to users of financial statements, same opinion supported by some of the IASB members. Some of respondents also not agree with idea that goodwill as an asset.

3.1.3.2. Comments to subsequent accounting

In the article “Preparers’ and Non-Preparers’ Lobbying on the Proposed Prohibition of Goodwill Amortisation in ED3 ‘Business Combinations’ ” by Fredrik Hartwig, Senior lecturer from Dalarna University (Sweden), we found very interesting opinions and hypothesis for current thesis problems. In the previous section (3.1.1.2), we have made an assumption that maybe current subsequent goodwill accounting is not correct, because it can be expensive, and complex.

Mr. Fredrik Hartwig analysed 124 comment letters according to subsequent goodwill accounting. The results are: 94 respondents have clear position about the topic. 54 respondents support amortisation and 40 do not. From those who support amortisation there are 19 preparers of reports (companies) and 35 of non-preparers (Consulting, Audit firms and other organisations).

Arguments were as follows:
Institute of Chartered Accountants in England & Wales: “‘…we strongly disagree that all goodwill should be subject to ‘impairment only’ regime […] goodwill and identified intangibles, which are similar in nature, will be subject to different accounting treatment. This diminishes comparability and reliability…”
Kingston Smith: ‘We also believe that the impairment review will cause an unnecessary burden and additional cost for smaller businesses”

The analysis showed that on the side of preparers of financial statements, there are many disputes in the accounting for goodwill. Some respondents or even the board members do not agree as to the obtaining of goodwill accounting technique and with its subsequent accounting. Some respondents believe the current accounting method unreliable, not useful, subjective, too expensive and complicated

For our survey we can mention some questions from here as well:

- Can we evaluate goodwill as reliable and useful?

3.1.4 Conclusion on analysis of regulations and official comments

Financial standards analysis showed that the current model of accounting for goodwill is very controversial. There are questions about the role of goodwill in the financial statements and the credibility of goodwill content.

In this chapter, we have highlighted some controversial points in form of questions. Because the author of this thesis does not have a lot of experience of work in the field of finance, it was decided to ask questions identified a group of people who have sufficient experience and education, in a fractional sample of people, issues and objectives of the survey will be discussed in Part 3.3

Now we can identify major issues that emerged from the analysis we described in this chapter:

- Financial report will be more efficient if goodwill be decreased proportional to profits from the related company?
- Financial report will be more efficient if goodwill be decreased in equal parts in a period of use (amortization principle)?
- Financial report is efficient because goodwill is testing on impairment or complex procedure makes it less efficient?
- Can we evaluate goodwill as reliable and useful?

While taking into account the analyzed material we can say that today the goodwill of financial statements is a: difference in the price of purchased companies and their net assets. This difference is tested for impairment using DCF, and hence is a subjective expectation of cash flows from acquired businesses by management of the company.

At the moment, we can put forward the following hypothesis about the possible use of goodwill users reporting:

- From two companies, with an equal amount and structure of assets and liabilities will bring more revenue one that has larger the value of goodwill. However, this statement could only take place in case the calculation of the price for purchase of the subsidiary and the subsequent revaluation would have done the same person.
- Goodwill can serve as a kind of stabilizer indicator of ROA, (return in assets) for the parent company. Because, in the absence of goodwill this figure would include the value of all the acquired

companies. And if this figure takes into account the goodwill, we can only see the profitability of the parent company only.

3.2 Investor view on goodwill

3.2.1 Analysis of investment companies reports

Initially it was decided that for this study it would be useful to know the opinion of the leading investment banks about goodwill as an indicator for the evaluation of investment attractiveness of the companies. For this purpose, the author has investigated reports which were available on the bank's websites. Materials were viewed by banks from the list below:

- Goldman Sachs
- Morgan Stanley
- JPMorgan Chase
- Bank of America Merrill Lynch
- Deutsche Bank
- Citigroup
- Credit Suisse
- Barclays Capital
- UBS
- HSBC
- Nomura Holdings
- RBC Capital Markets
- BNP Paribas
- The Royal Bank of Scotland Group
- TD Securities
- Wells Fargo
- Lazard
- Jefferies Group
- Société Générale
- BMO Capital Markets

However, there was found, any statements, opinions or less ods estimates include goodwill.

3.2.2 Warren Buffet opinion

Warren Edward Buffett American entrepreneur, the world's largest and one of the most famous investors, whose state is on September, 2013 was at 58.5 billion dollars, according to Forbes. Also according to Forbes lists he is second richest man in USA, number 13 in the list of powerful people, and second in Forbes 400. He is considered one of the most successful investors in the world. He is a writer of famous investments books.

Warren Buffet is very respectful figure in a investments world so it looks reasonably to listen for his opinion about the goodwill as well. One of such books is “The Essays of Warren Buffett: Lessons for Corporate America”. In this book Buffett point out his opinion about goodwill. Buffett highlights the important differences between accounting and economic goodwill.

Accounting goodwill is essentially the amount by which the purchase price exceeds the fair value of the acquired assets. Economic goodwill is a combination of intangible assets, including brand awareness, which helps the company to profit from tangible assets in excess of the average rate. The magnitude of economic goodwill - it is the capitalized value of such excess.

From one side he points out that accounting goodwill is a real cost that cannot be recovered if the intrinsic value of the acquired business is lower than its selling price. “Because it can’t go anywhere else, the silliness ends up in the goodwill account. Considering the lack of managerial discipline that created the account, under such circumstances it might better be labelled ‘No-Will’.” Berkshire Hathaway also accounts for economic goodwill – the difference between the tangible and the intrinsic value of the business. This type of goodwill is what matters to Buffet. When he acquired See’s Candy Stores in 1972, he paid $17 m more than its net tangible assets, but the economic goodwill from the deal is much more than the accounting goodwill.

But from another side Buffet considers method of accounting goodwill which is currently in effect as most appropriate to take into account the difference in price and the net assets value. On his opinion such method satisfies accountants or others who want to disclosure accounting goodwill in the financial reports and it will satisfy managers who are not agree with amortisation deductions.

3.2.3 Interviews

Author has performed short interviews about the topic with three analysts with experience from two to five years of evaluation and investments. Interviews were in a free form and short. We can summarise the results as:

- Accounting goodwill is not a business reputation and should not be considered as that
- Goodwill can be used as a supportive information about the acquisitions done
- Goodwill should be considered as an expense but not as an asset
- Investors are more likely to use P&L for evaluation rather than Balance

3.2.4 Summary

There were examined a lot of resources such as reports of investment companies, publications in journals, books, as well as views of famous and influential people on the issue. However, concrete ideas on the use of accounting goodwill in making investment decisions have not been found. It is also worth noting that found many publications critical of the current and previous versions of the standards for accounting for goodwill.

3.3 Survey

After analysis made in previous chapters which include analysis of IASB regulations of goodwill, comment letters and exposure drafts, opinions of expert, author collected several questions which have to be answered by professionals, who directly or indirectly working with goodwill.

3.3.1 Target group

Author decided that people who may satisfy criteria mentioned below, are include managers, private investors, banks employees and other users of financial statements. As well on the other side such people are auditors, accountants, financial advisors and other professionals who are involved to preparation of the financial statement.

Target group was chosen as users and perpetrators of financial reports as most familiar with the subject. Through personal contacts of the author, link to the survey was sent to about 200 people who work in the Big 4 of audit firms (KPMG, EY, PwC, Deloitte), investment banks. Survey invitation was sent to people from Germany, Spain, Estonia, Finland and Russia.

3.3.2 Questions

Survey was containing two parts: first part is personal information about the respondents which we need for our segmentation of answers.

Survey questions were designed to get answers to questions arising during of this study. The idea is to get a view of a group and associate it with the education and experience of the respondents.

Definitely our target group is very busy people with the lack of free time, for this reason survey list was designed to be passed as soon as possible. Survey was made as online questionnaire without mandatory fields, and provided list of answers as well as field for typing own answer.

The questions of the survey were divided into two groups:

- Opinion about goodwill under IFRS 3
- Opinion about goodwill in accounting

The idea of such deviation is to understand firstly what respondents think about IFRS regulation of goodwill accounting, and in the second part to get their opinions about accounting of difference between purchase price and fair value of the assets. In other words author expected to get agrees or disagrees with current version and if disagrees were found, to ask about their vision of how if have to be accounted.

The question were designed and developed by author as follows:
First part of the questions “Opinion about goodwill under IFRS 3”:

1. ***Do you agree with current version of IFRS 3 in terms of initial recognition of Goodwill?***

Question was supplied with a comment: “That difference between purchase price and fair value of net assets is an intangible asset”

2. ***Do you agree with current version of IFRS 3 in terms of subsequent test for impairment?***

Question was supplied with a comment: “Based on the nature of goodwill is it the most appropriate method?”

Those two questions were mentioned as most controversial in the beginning of the research by the commissioning organization as well as in a chapter about IFRS analysis.

In the second part “Opinion about goodwill in accounting” respondents were asked to give the answer according to your personal understanding of financial reporting and not according to IFRS. The questions are listed below:

3. ***Do you agree with an opinion that Goodwill may be interpreted as an expectation of future profits of the buyer company?***

This question was designed according to the opinion that any acquisition is carried out for reasons that it will bring some benefits in the future.

4. ***Do you agree with the opinion that if the Goodwill will be accounted as an expense instead of asset, the Balance sheet will reflect more reliable information about company financial situation?***

This question is a product of the IFRS analysis as well as of analysis of exposure drafts and comment letters as well as investors view on goodwill analysis. Preconditions to this question can be found in the chapters 3.1 and 3.2. This question is logically connected and theoretically opposite to question 1.

5. ***Do you agree with an opinion that Goodwill should be decreased proportional to profits from the related company?***

We made an assumption that this method of subsequent goodwill accounting could be the right method if we assume that goodwill is a NPV of future cash flows.

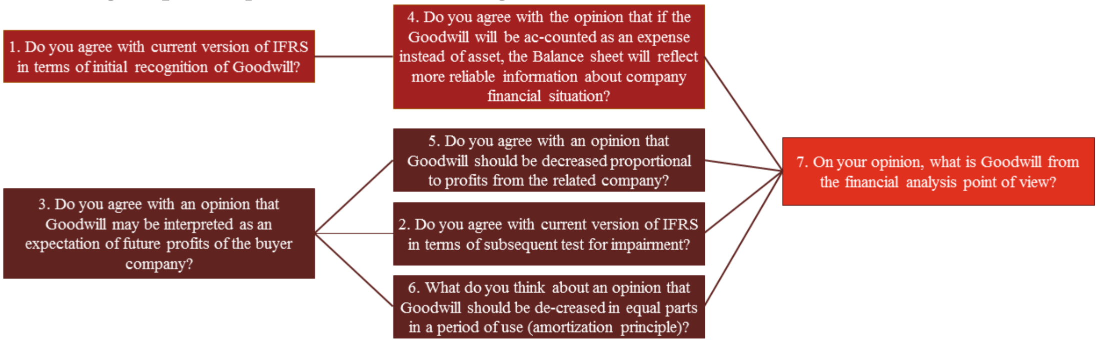
6. ***What do you think about an opinion that Goodwill should be decreased in equal parts in a period of use (amortization principle)?***

Together with previous question the idea is to understand what the most appropriate goodwill subsequent accounting method is.

7. ***On your opinion, what is Goodwill from the financial analysis point of view?***

The idea of this question is to find out can goodwill be used somehow in financial analysis, and to understand can we rely on it or not.

We can group our question as on the figure blow:



3.3.3 Results

3.3.3.1. Background of respondents

Survey invitation was sent approximately to 200 people, however responds rate was about 25% or 50 responds which is small but understandable because target group is very busy people and their schedule is very tight.

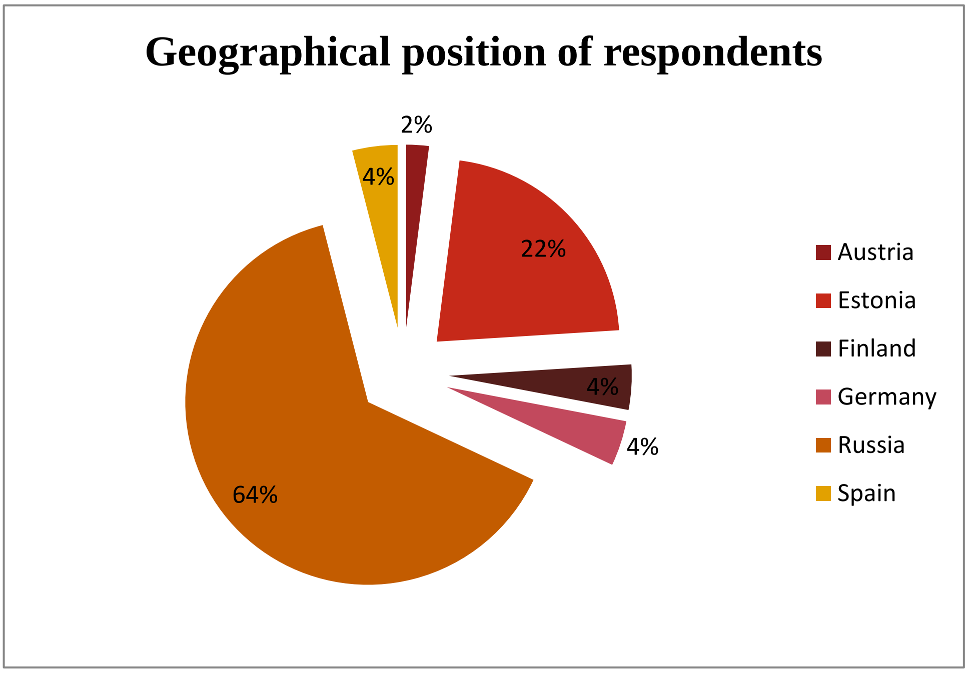
To form segments from the respondents they were asked about their geographical position, professional field, educational background, years of work experience.

3.3.3.1.1. Geographical positions

Geographical positions of respondents are presented on the table below:

Austria	1	2%
Estonia	11	22%
Finland	2	4%
Germany	2	4%
Russia	32	64%
Spain	2	4%
Total	**50**	**100%**

Table 13 Breakdown of respondent’s geographical position.



Most of the respondents are from Russia, and Estonia, invitations there was sent mostly through corporate emails. Also author was trying to make this research international and was sending invitations selectively from the personal contacts in LinkedIn.

3.3.3.1.2. Professional field

As we mentioned before we want to know the opinions of respondents from the different reporting sides: from propagators (accountants, auditors, consultants) and users (investors, shareholders). As we can see from the table and chart below, most respondents (80%) from the preparation side, it mostly because the representatives of users of the report were less inclined to cooperation

Preparation side	41	82%
User side	9	18%
Total	**50**	**100%**

Table 14 Breakdown of respondent's professional side of using financial reports.

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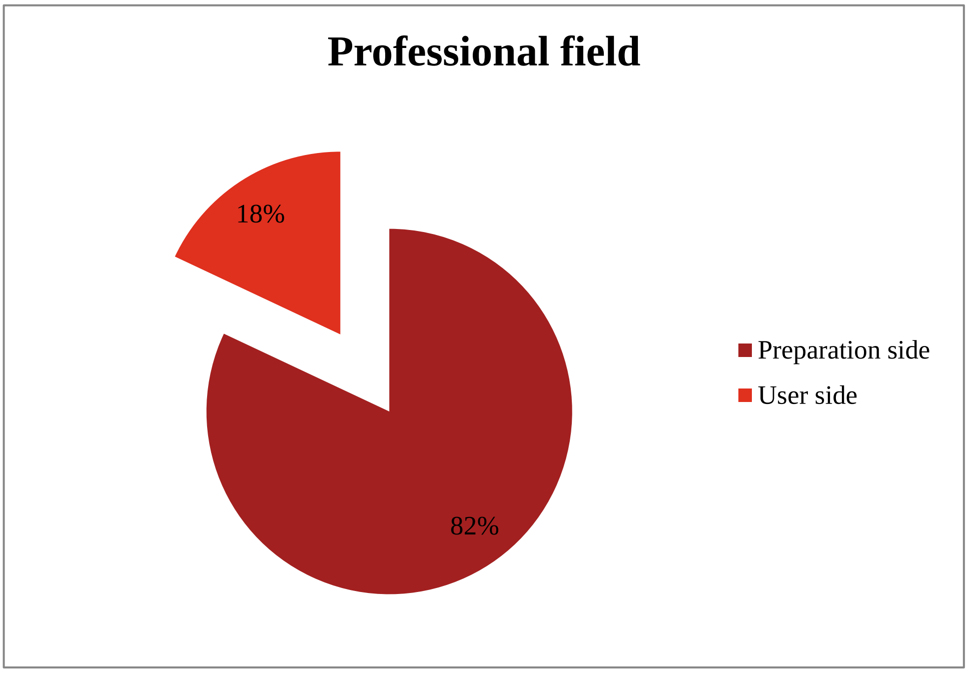
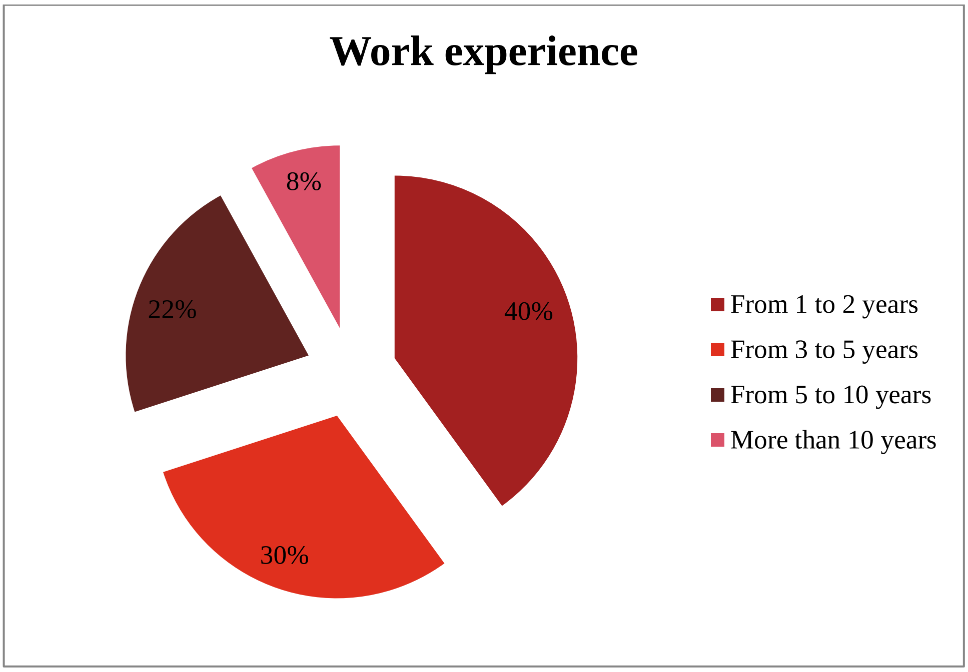


3.3.3.1.3. Work experience

Work experience is very important factor for this research because it represents not just using of existing standards but also application of own vision of reporting. Breakdown presented in the table and chart below.

From 1 to 2 years	20	42%
From 3 to 5 years	15	28%
From 5 to 10 years	11	22%
More than 10 years	4	8%
Total	**50**	**100%**

Table 15 Breakdown of respondent's by experience groups.



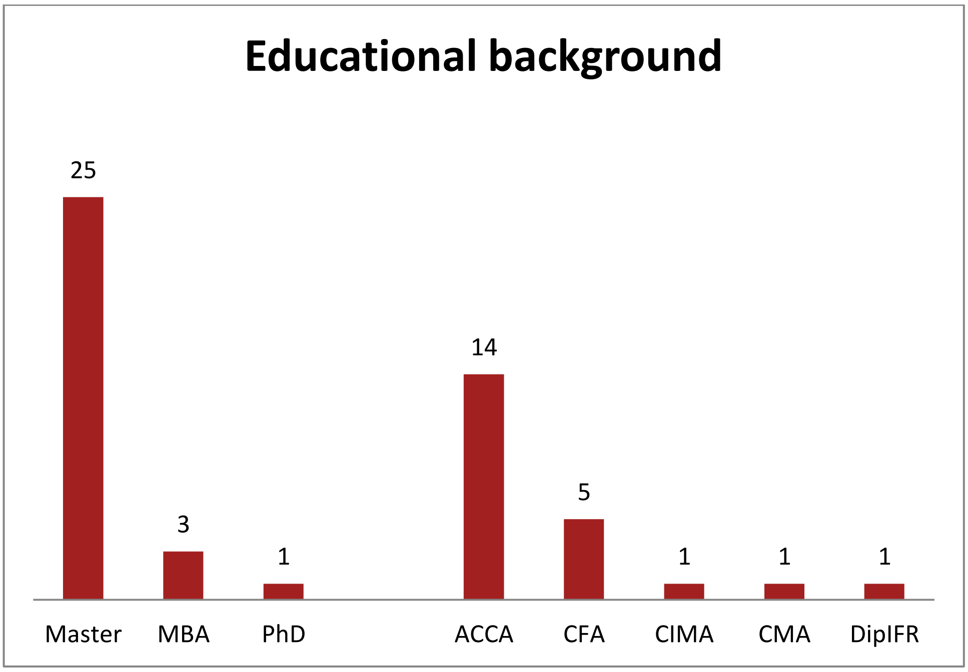
Most of the responds we got from the young professionals who work 1 or 2 years in the industry, similar parts of 30% and 22% came from respondents with experience from 3 to 5 and from 5 to 10 respectively. Also we got 8% or 4 responds from respondents with more than 10 years of work experience in the industry, also we can mention that those respondents are from the preparation side of the reporting process.

3.3.3.1.4. Educational level

We made possible to mark from the list educational level and certificates. There was a list of most popular certificates related to finance and degree levels. Results are presented below on table and chart, we do not show that 47 respondents have bachelor degree and 3 respondents have specialist degree (5 years degree, which is common for Russia) because our target group is employed people who have a bachelor degree by default. Higher degrees and certificates are presented below.

Degree	**People**
Master	25
MBA	3
PhD	1
Certificates	**People**
ACCA	13
Other	7
CFA	5
CIMA	1
CMA	1
DipIFR	1
AAPA	1
Other (local)	4

Table 16 Certificates and highest degrees of respondents.



We can see that 25 (50%) respondents are Masters, 3 respondents hold MBA and 1 respondent is PhD.

Most share (28%) of the respondents belong to the Association of Chartered Certified Accountants (ACCA) also relatively significant share (10%) of the respondents indicated that they are Chartered Financial Analyst (CFA), decryption abbreviations certificates can be found in the appendix.

3.3.3.2. Analysis of answers

As was mentioned before we got 50 responds and now we will analyse the answers given below:

3.3.3.2.1. Questions 1 and 4.

Question 1: Do you agree with current version of IFRS 3 in terms of initial recognition of Goodwill?
Answers:
No 8
Yes 42

Question 4: Do you agree with the opinion that if the Goodwill will be accounted as an expense instead of asset, the Balance sheet will reflect more reliable information about company financial situation
Answers:
Agree 16
Disagree 34

As a result of question 1, we got 8 “No” answers, and 42 “Yes”, so we can see that 84% of respondents evaluate the difference of purchase price as an asset or at least that this amount should be accounted. However from the question 4 answers we got 16 respondents who agreed that goodwill is an expense, 9 respondents, or 21% of those who agreed with current accounting principles, prefer to recognize goodwill as an expense.

Let us consider answers grouped by professional field and experience is on the table below:

	Exepirence	>10 years	1-2 years	3-5 years	5-10 years	**Total**
no	**Total**		**3**	**4**	**1**	**8**
	Preparer side		2	3	1	**6**
	User side		1	1		**2**
yes	**Total**	**4**	**17**	**11**	**10**	**42**
	Preparer side	4	13	9	9	**35**
	User side		4	2	1	**7**

Table 17 Breakdown of answers by professional field and experience.

As we see, in all work experience groups prevails an opinion that goodwill should be recognized as asset. The most experienced group of respondents agree with IFRS in 100% of the group, 85 % of young professionals, 73% of “3-5 years” group, and 91% of “5-years” group. As we can see 77% respondents from the users of reports side agree with current standards. Breakdown by certificates and education presented on the tables below:

	ACCA	CFA	CIMA	CMA	DipIFR
Do not agree with IFRS 3	14 %	20 %	100 %	0 %	0 %
Agree with IFRS 3	86 %	80 %	0 %	100 %	100 %
Total	**14**	**5**	**1**	**1**	**1**

Table 18 Answers on question 1 grouped by certificates received.

	ACCA	CFA	CIMA	CMA	DipIFR
Goodwill - is expence	36 %	20 %	100 %	0 %	0 %
Goodwill - is not expence	64 %	80 %	0 %	100 %	100 %
Total	**14**	**5**	**1**	**1**	**1**

Table 19 Answers on question 4 grouped by certificates received.

	Bachelor	Specialist	Master	MBA	PhD	Total
no	18 %		15 %	33 %		18 %
yes	82 %	100 %	85 %	67 %	100 %	82 %
Total	**17**	**3**	**26**	**3**	**1**	**50**

Table 20 Answers on question 1 grouped by received degree.

	Bachelor	Specialist	Master	MBA	PhD	Total
agree	29 %		35 %	67 %		32 %
disagree	71 %	100 %	65 %	33 %	100 %	68 %
Total	**17**	**3**	**26**	**3**	**1**	**50**

Table 21 Answers on question 4 grouped by received degree.

As we can see, with current version of goodwill recognition disagreed 18% of bachelors, 15% of Masters and 33 % of MBA people. However 29% Bachelors, 35% Masters 67% of MBA would like to recognize goodwill as an expense. Almost in each education degree we see that there are some respondents who agree with current standard but in the same time would prefer to account goodwill as an expense. Some respondents also leaved comments.

Comments can be interpreted as below:

- We definitely buy something and should show it as an asset
- All approaches are not perfect

From the responds of question 1 and question 4 we can conclude that biggest share of users and preparatory agree with current version of goodwill recognition however there significant part of those who consider goodwill as an expense.

3.3.3.2.2. Questions 2,3,5,6

One of the questions of this research is “which subsequent accounting of goodwill is more correctly reflects the nature of the subject”? For that purpose we designed this group of questions 2,3,5,6. Here we have four questions which are aimed to find out best approach for subsequent accounting on opinion of survey respondents.

Question 3: Do you agree with an opinion that Goodwill may be interpreted as an expectation of future profits of the buyer company?
Answers:
No 11
Yes 39

Question 5: Do you agree with an opinion that Goodwill should be decreased proportional to profits from the related company?
Agree 20
Disagree 30

In chapter 3.1 we concluded that goodwill is mainly driven by purchase price, which usually represent amount which indirectly calculated by DCF method, another words we assumed that goodwill is driven by future cash flows which acquires expect to receive from the deal. So we decided to test our hypothesis by asking the related question in the group surveyed. Based on this hypothesis, in the chapter 3.1.1.2 we have assumed that it may be more correct to decrease amount of goodwill in proportion of income cash flows from acquired business. Now let us consider answers for the relevant questions 3 and 5 in breakdowns to work experience, reporting side and education:

	Preparer side	User side	Total
no	8	3	**11**
1-2 years	2	2	**4**
3-5 years	3	1	**4**
5-10 years	2		**2**
>10 years	1		**1**
yes	33	6	**39**
1-2 years	13	3	**16**
3-5 years	9	2	**11**
5-10 years	8	1	**9**
>10 years	3		**3**
Total	41	9	**50**

Table 22 Breakdown of answers to question 3 on professional side and experience.

We can see that 20% of the preparers and 33% of users do not agree with the assumption. Some answers were supported with comments from preparatory side that there might be too much of other factors which impact on future profits. Respondent with DipIFR qualification commented that it is more likely a current cost because in future there might me changes in activities and in cash flows as well. Respondent with 3-5 years of work experience, master degree and ACCA qualification commented that synergy effect is too complicated to calculate before deal, there is too much of factors which can change the purchase price, which include even personal negotiation skills of managers and shareholders.

So in general we can assume that respondents support the idea that goodwill can be related to future cash flows from the acquisition. Consequently, if we say that goodwill is future cash flows then maybe goodwill should be decreased proportionally when cash flows comes to the company (Question 5)? Let us consider answers in different variations of breakdowns bellow:

	Preparer side	User side	Total
Agree	18	2	**20**
>10 years	1		**1**
1-2 years	6	1	**7**
3-5 years	8	1	**9**
5-10 years	3		**3**
Disagree	23	7	**30**
>10 years	3		**3**
1-2 years	9	4	**13**
3-5 years	4	2	**6**
5-10 years	7	1	**8**
Total	41	9	**50**

Table 23 Breakdown of answers to question 5 on professional side and experience.

	Bachelor	Specialist	Master	PhD	MBA	Total
Agree	59%		35%		33%	**20**
Disagree	41%	100%	65%	100%	67%	**30**
Total	**17**	**3**	**26**	**1**	**3**	**50**

Table 24 Breakdown of answers to question 5 grouped by received degree.

	ACCA	CFA	CIMA	CMA	DipIFR
Agree	50%				100%
Disagree	50%	100%	100%	100%	
Total	**14**	**5**	**1**	**1**	**1**

Table 25 Answers on question 5 grouped by certificates received.

From the table above we can see that 40% of respondents agree with our assumption, and 60% disagree. Answers are uniformly distributed as groups by experience and on the sides of reporting, no correlation was detected. You may notice that the side of preparers split almost equally (44% and 56%), whereas on the side of users of financial statements, most disagree with our assumption (22% and 78%). Some of respondents supported their answers with comments. Some of respondents agree that goodwill should be decreased in proportion or some other complicated methods, such comments came from respondents with 5-10 years of experience and from the ACCA member with 3-5 years of work experience. Opposite comment, that this method is too complex came MBA with 3-5 years of experience.

We briefly describe below the main ideas of comments about proposed method below:

- Too complicated
- Same idea with impairment but more complicated

In fact comments are appropriate, in this research author mentioned that impairment method is subjective, complicated and expensive, but proposed method which is definitely more complex, expensive, and risky for errors.

Now we found out that our proposed method is not suitable in the opinion of the respondents. Let us analyse the opinion of a group of current and previous methods of subsequent accounting of goodwill (Question 2 and Question 6).

Question 2: Do you agree with current version of IFRS 3 in terms of subsequent test for impairment?

No 14
Yes 36

Question 6: What do you think about an opinion that Goodwill should be decreased in equal parts in a period of use (amortization principle)?

Agree 15
Disagree 35

Breakdowns of the answers divided by groups of respondents can be found below.

	Bachelor	Specialist	Master	MBA	PhD	Total
Disagree with impairment	24%		35%	33%		**14**
Agree with impairment	76%	100%	65%	67%	100%	**36**
Total	**17**	**3**	**26**	**3**	**1**	**50**

Table 26 Breakdown of answers to question 2 grouped by received degree.

	Bachelor	Specialist	Master	MBA	PhD	Total
Agree with depreciation	29%	33%	27%	33%	100%	**15**
Disagree with depreciation	71%	67%	73%	67%		**35**
Total	**17**	**3**	**26**	**3**	**1**	**50**

Table 27 Breakdown of answers to question 6 grouped by received degree.

	ACCA	CFA	CIMA	CMA	DipIFR
Disagree with impairment	21%	20%	100%	100%	
Agree with impairment	79%	80%			100%
Total	14	5	1	1	1

Table 28 Answers on question 2 grouped by certificates received.

	ACCA	CFA	CIMA	CMA	DipIFR
Agree with depreciation	21%	20%	100%	100%	
Disagree with depreciation	79%	80%			100%
Total	14	5	1	1	1

Table 29 Answers on question 6 grouped by certificates received.

Those two questions are opposite and we can see that responses are opposite as well, on the degree received and on the certificates breakdowns. We can clearly see that majority of respondents prefer current version of goodwill subsequent accounting.

Comments of the respondents can be interpreted as ideas presented below:

- Amortisation method does not reflects economic nature of goodwill fluctuation
- Eventually goodwill should be written off through P&L

Let us consolidate answers on the questions about subsequent accounting (Questions 2, 5, 6) in the table below

	Proportional decreasing	Depreciation	Impairment
Agreed with method (respondents)	20	15	36
Disagree with method (respondents)	30	35	14

Table 30 Consolidated responds about subsequent accounting of goodwill.

Consolidated SWOT analysis of the methods

	Proportional decreasing	Depreciation	Impairment
Strengths	Reflect mathematical essence of goodwill	Easy Cheap use	Reflects economical essence of goodwill
Weakness	Hard to implement	Not fully reflects economic condition of goodwill	Subjective Expensive
Opportunities	Development of regulation	N/A	Clearer regulations revaluation
Threats	Mistakes can be allowed	N/A	Depends on external factors (Market, economy, etc.)

Table 31 SWOT analysis of goodwill subsequent accounting methods.

Despite differences in responses, we can conclude that testing for impairment is the most appropriate method of subsequent accounting for goodwill. It is less likely that IASB will bring back amortisation principle and method of proportional decrease is too complicated to be performed.

3.3.3.2.3. Question 7

The last question we asked respondents was: "On your opinion, what is Goodwill from the financial analysis point of view?"

Answers:

Useful and safe	10
Useful but not reliable	32
Useless but safe	5
Creates a wrong judgment	3

Let us consider breakdowns of answers below.

	>10 years	1-2 years	3-5 years	5-10 years	Total
Useful and safe		4	2	4	10
Useful but not reliable	4	13	10	5	32
Useless but safe		3	2	1	6
Create a wrong judgment			1	1	2
Total	4	20	15	11	50

Table 32 Breakdown of answers to question 7 on professional side and experience.

We can notice that most experienced group classifies goodwill as useful but not reliable.

	Bachelor	Specialist	Master	MBA	PhD	Total
Useful and safe	12%	33%	23%	33%		10
Useful but not reliable	71%	67%	62%	33%	100%	32
Useless but safe	12%		12%	33%		6
Create a wrong judgment	6%		4%			2
Total	17	3	26	3	1	50

Table 33 Breakdown of answers to question 7 grouped by received degree.

	ACCA	CFA	CIMA	CMA	DipIFR
Useful and safe	29%	40%			
Useful but not reliable	57%	40%	100%	100%	100%
Useless but safe		20%			
Create a wrong judgment	14%				
Total	1	1	1	1	1

Table 34 Answers on question 7 grouped by certificates received.

We can see that majority of all groups of education and certificates classify goodwill as Useful but not reliable. Which meant that on opinion of majority goodwill as an account in balance sheet can exist and be used however current regulations do not control it enough, and the problem here is subjective of the impairment.

3.3.4 Survey summary

Majority of the respondents agree with IFRS in terms of initial recognition of goodwill, however there are a significant part of respondents who agree that by nature it is not an asset and should be written off as expense.

Respondents showed that on their opinion goodwill as an asset may be a present value of future cash flows, but there is a very big component of other factors, such as negotiation skills of managers, overestimation of future benefits, etc.

Survey analyse showed that most appropriate method of goodwill subsequent accounting already proposed by IASB, however, in practice this method is very subjective and makes goodwill less reliable.

Survey research showed that goodwill can be used by investors or other reports users, but regulation should be increased. For example to delete component of subjective, goodwill impairment testing may be done only by independent parties.

4 CONCLUSION

This thesis work was aimed finding the most appropriate method for accounting of an excess of the consideration transferred to controlling shareholders over the fair value of net assets of acquired company, with current regulations under IFRS. This objective was divided into questions which were answered in this research project:
What goodwill really means as an asset?
By its nature, is goodwill an asset or an expense?
Which subsequent accounting of goodwill more correctly reflects the nature of the subject?
Can investors or readers of reports use goodwill under current regulations?

To find the most applicable answers this research project was designed in the form of three analyses: an analysis of IFRS regulations, an analysis of investors' opinions, and an analysis on the implemented survey.

The following results were acquired:

What goodwill really mean as an asset?
We made the conclusion that goodwill is not business reputation or about other intangible definitions which can be found in literature. It is a mathematical value which has a calculation formula and drivers. However, goodwill is not exact and subjective. Our assumption was confirmed by the survey.

By its nature, is goodwill an asset or an expense?
We made the conclusion that goodwill should not be accounted as an asset but as an expense. Our assumption was partly supported by Warren Buffet in his essays, as well as by the interviewees from the investments field. Survey results showed that a majority of respondents disagreed with that assumption but some part agreed as well.

Which subsequent accounting of goodwill is more correctly reflects the nature of the subject?
We made the assumption that goodwill represents future cash flows and the most appropriate method of subsequent accounting is proportional decreasing of goodwill by incomes. Our assumption was not supported by the investors and by the survey. We found out that this method is too expensive and difficult to implement, so there is a high probability of errors. Under the investors analysis we also studied Warren Buffet opinion about the subject and he believes that if goodwill is considered as an asset, it is necessary to implement an impairment test. A majority of survey respondents agreed with Warren Buffet, we are also convinced that a fraud risk exists in the implementation of an impairment test.

Can investors or users of the reports use goodwill under current regulations?

We made an assumption that nowadays goodwill is very subjective value which is not easy to be compared between companies. We did not find any materials in open access about using goodwill for investment decisions. The survey showed us that respondents believed that goodwill can be used, even if it is not reliable at the moment.

This research project showed that goodwill is not very important for reporting users or investors, but current regulation make accounting of this line item very expensive and not reliable. On the author opinion the best development of the standard from the IASB will be tightening the current regulations to eliminate subjectivity of accounting. But this approach will still drive to costs of accounting. Another reasonable recommendation is to account goodwill as an expense from the acquisition. This will save time, budget for finance function, and there will be no subjectivity either.

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Appendix 1

LIST OF COMPANIES RESPONDENTS TO PROPOSED AMENDMENTS TO IAS 27 BUSINESS COMBINATIONS

1	Accounting Principles and Auditing Standards Committee of the Florida Institute of Certified Public Accountants
2	Accounting Standards Board (ASB)
3	Accounting Standards Board of Japan (ASBJ)
4	ACME (European Insurance Mutuals and Cooperatives Association)
5	Association of Chartered Certified Accountants (ACCA)
6	Association of Friendly Societies
7	ACTEO and MEDEF
8	Australian Accounting Standards Board (AASB)
9	Britannia
10	Caisse Nationale des Casises d'Epargne
11	Canadian Association of Mutual Insurance Companies
12	Canadian Co-operative Association
13	CFA Institute
14	Chartered Institute of Management Accountants
15	Conseil National de la Comptabilitй (CNC)
16	Confcooperative
17	Coop de France
18	COOPERATIVA ACAC
19	Cooperative and Raiffeisen Confederation of Baden (BGV)
20	Cooperatives Organizations on Colombia (Columbia)
21	Coordinating Committee of European Cooperative Associations (CCACE)
22	Council on Corporate Disclosure and Governance (CCDG)
23	Credit Agricole S.A
24	Credit Mutuel
25	CUDECOOP is the Uruguayan Confederation of Cooperatives of Uruguay (Uruguay)
26	Deloitte Touche Tohmatsu (International)
27	Ernst & Young (International)
28	European Association of Co-operative Banks
29	European Association of Cooperative Groups
30	European Financial Reporting Advisory Group (EFRAG)
31	European Savings Banks Groups
32	Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand
33	F Hoffmann-La Roche
34	Fцreningen Auktoriserade Revisorer FAR
35	French Groupement National de la Cooperation (GNC)
36	General Confederation of Agricultural Co-operatives in the European Union
37	Genossenschaftsverband Norddeutschland e.V
38	German Accounting Standards Committee (DRSC)
39	KPMG (international)

40	German Cooperative and Raiffeisen Confederation DGRV
41	Group of 100
42	Industrie-Holding
43	Institut der Wirtschaftsprъfer (IDW)
44	Institute of Chartered Accountants in England & Wales (ICAEW)
45	Institute of Chartered Accountants in Ireland (ICAI)
46	Institute of Chartered Accountants of Scotland (ICAS)
47	International Actuarial Association (IAA)
48	International Accounting Standards Review Committee (IASRC) of theKorea Accounting Standards Board (KASB)
49	International Accounting Standards Working Group of the National Association of Insurance Commissioners (NAIC)
50	International Co-operative Alliance
51	International Co-operative Alliance Regional Office for Asia and Pacific
52	International Cooperative & Mutual Insurance Federation
53	Japanese Consumers' Co-operative Union
54	Japanese Institute of Certified Public Accountants (JICPA)
55	Koimburi Tucker & Muya
56	Life Insurance Association of Japan
57	London Society of Chartered Accountants (LSCA)
58	MERCOSUR Specialized Cooperative Conference (RECM)
59	Monash University
60	National Association of Mutual Insurance Companies
61	National Cooperative Business Association
62	National Union of Workers Producers Co-operatives of Bulgaria
63	Papadopoulos, Alecos
64	PricewaterhouseCoopers (International)
65	Raad voor de Jaarverslaggeving (Council for Annual Reporting)
66	South African Institute of Chartered Accountants (SAICA)
67	Swedish Financial Accounting Standards Council
68	UK 100 Group
69	Union of Industrial and Employer’s Confederations of Europe (UNICE)
70	World Council of Credit Unions, Inc
71	ZGV e. V.

Appendix 2

LIST OF COMPANIES RESPONDENTS TO PROPOSED AMENDMENTS TO IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

1	Israel Accounting Standards Board Israel (Israel)
2	Christoph Fröhlich Vienna University of Economics & Business Administration (Austria)
3	Karl Hoffmann (Germany)
4	Consiglio Nazionale dei Dottori Commercialisti and Consiglio Nazionale dei Ragionieri (Italy)
5	Bundesverband deutscher Banken (Germany)
6	Canadian Accounting Standards Board (Canada)
7	CPA Australia (Australia)
8	Barclays Bank (UK)
9	Mazars (France)
10	Conseil National de la Comptabilité (CNC) (France)
11	Ramaiah Devaraj & Co.Chartered Accountants (India)
12	Korea Accounting Association (Korea)
13	Telstra (Australia)
14	Association of British Insurers (ABI) UK
15	Munich Re Group (Germany)
16	Föreningen Auktoriserade Revisorer FAR (Sweden)
17	London Society of Chartered Accountants (LSCA) (UK)
18	France Telecom's, Telefónica´s and Deutsche Telekom [Joint Response]
19	German Accounting Standards Committee (DRSC) Germany
20	Rishi Albert
21	Dutch Accounting Standards Board (Netherlands)
22	AXA Group (France)
23	Irish Bankers Federation (IBF) (Ireland)
24	Fletcher Building (New Zealand)
25	F Hoffmann La Roche (Switzerland)
26	ING Group (Netherlands)
27	Société Générale (France)
28	The International Accounting Standards Review Committee (IASRC) of the Korea Accounting Standards Board (KASB) (Korea)
29	Institute of Chartered Accountants of Zimbabwe (ICAZ) (Zimbabwe)
30	British Bankers' Association (BBA) (UK)
31	BG Group PLC (UK)
32	South African Institute of Chartered Accountants (SAICA) Accounting Practice Board (APB)
33	Accounting Standards Board of Japan (ASBJ) (Japan)
34	Anglo American Plc
35	The Chartered Institute of Management Accountants (CIMA) (UK)
36	The Standard Bank Group (South Africa)
37	Royal Bank of Scotland (UK)

38	KPMG (International)
39	RWE Aktiengesellschaft (Germany)
40	UK 100 Group (UK)
41	Grant Thornton Chartered Accountants
42	Zambia Institute Of Chartered Accountants (Zambia)
43	Holcim Group Support (Switzerland)
44	Institute of Chartered Accountants in England & Wales (ICAEW) UK
45	Federation of Swiss Industrial Holding Companies (Switzerland)
46	Unilever (UK)
47	BNP Paribas France
48	Royal Dutch Shell plc
49	Financial Reporting Council (FRC) and the IFRS Issues Committee at the Institute of Professional Accountants of Russia (IFRS Committee) Russia
50	Syngenta International AG
51	PricewaterhouseCoopers (International)
52	Institut der Wirtschaftsprüfer (IDW) (Germany)
53	Association pour la participation des entreprises françaises à l'harmonisation comptable internationale (ACTEO) and Mouvement des Entreprises de France (MEDEF) (France)
54	Treuhand-Kammer Switzerland
55	Nestlé Switzerland
56	The Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand (ICANZ) and the Accounting Standards Review Board (ASRB) (New Zealand)
57	Institute of Certified Public Accountants in Ireland (Ireland)
58	Japanese Institute of Certified Public Accountants (JICPA) (Japan)
59	Dansk Industri (Confederation of Danish Industries) (Denmark)
60	FirstRand Banking Group (South Africa)
61	Confederation of Swedish Enterprise (SEAG) (Sweden)
62	Ernst & Young (International)
63	Credit Mutuel (France)
64	HSBC Holdings (UK)
65	Bill Hicks (UK)
66	Hong Kong Institute of Certified Public Accountants (Hong Kong)
67	Astrazeneca Plc (UK)
68	London Investment Banking Association (LIBA) (UK)
69	UBS AG (Switzerland)
70	International Actuarial Association (IAA)
71	Organismo Italiano di Contabilità (OIC) Italy
72	Council on Corporate Disclosure and Governance (CCDG) (Singapore)
73	Swedish Financial Accounting Standards Council (Sweden)
74	GlaxoSmithKline (UK)
75	Institute of Chartered Accountants of Scotland (ICAS) (UK)

76	BaFin and Deutsche Bundesbank (Germany)
77	Australian Accounting Standards Board (Australia)
78	European Financial Reporting Advisory Group (EFRAG)
79	International Organization of Securities Commissions (IOSCO)
80	Cazenove Equities (UK)
81	New Zealand Treasury (New Zealand)
82	British American Tobacco
83	Flick Gocke Schaumburg GMBH (Germany)
84	BDO Stoy Hayward
85	Confederation of British Industry (CBI) (K)
86	Fédération des Experts Comptables Européens (FEE)
87	Association of Chartered Certified Accountants (ACCA) (K)
88	Royal & Sun Alliance (UK)
89	Accounting Standards Board (ASB) (UK)
90	Omron Corporation (Japan)
91	London School of Economics (UK)
92	UK Society of Investment Professionals (UKSIP) UK
93	Union of Industrial and Employer's Confederations of Europe (UNICE)
94	Group of 100 (Australia)

Appendix 3

COMPARATIVE CHARACTERISTICS OF THE ACCOUNTING PRINCIPLES OF GOODWILL IN THE RAS AND IAS

Criterion	IFRS 3	RAS 14/2007
Definition	Goodwill acquired in a business combination represents a payment made by the acquirer in anticipation of future economic benefits from assets that cannot be individually identified and separately recognized	Goodwill should be considered as a premium paid by the buyer in anticipation of future economic benefits in connection with the acquired assets unidentifiable. Negative goodwill should be treated as a discount on the price provided by the buyer in the absence of factors for stable customers, reputation, quality, marketing and sales skills, business relationships, management experience, qualifications of personnel, etc.
Recognition as an object of accounting	Acquired in a business combination goodwill is recognized as an asset	Goodwill arising on acquisition of businesses is accounted for as intangible assets
Initial evaluation	Goodwill is initially measured at its cost, i.e. by the amount by which the cost of the business combination exceeds the share of the acquire in the net fair value of the identifiable assets, liabilities and contingent liabilities	For accounting purposes, the cost of purchased goodwill is calculated by the difference between the purchase price paid to the seller when purchasing enterprise as a property complex (in whole or part), and the sum of all assets and liabilities on the balance sheet at the date of purchase (purchase)
Subsequent evaluation	After initial recognition, the acquirer is required to measure acquired in a business combination goodwill at cost less any accumulated impairment losses	Subsequent measurement of goodwill is not applied
Depreciation	Goodwill acquired in a business combination is not amortized. Instead, according to IAS 36 "Impairment of As-	Acquired goodwill is amortized over 20 years (but not more than the life of the organization).

	sets", the acquirer shall, on an annual basis test Goodwill for impairment, or more frequently if the events or changes in circumstances indicate a potential impairment of it	Amortization expense for goodwill is determined by straight-line method. Negative goodwill in the full amount attributed to financial results of the organization as other income