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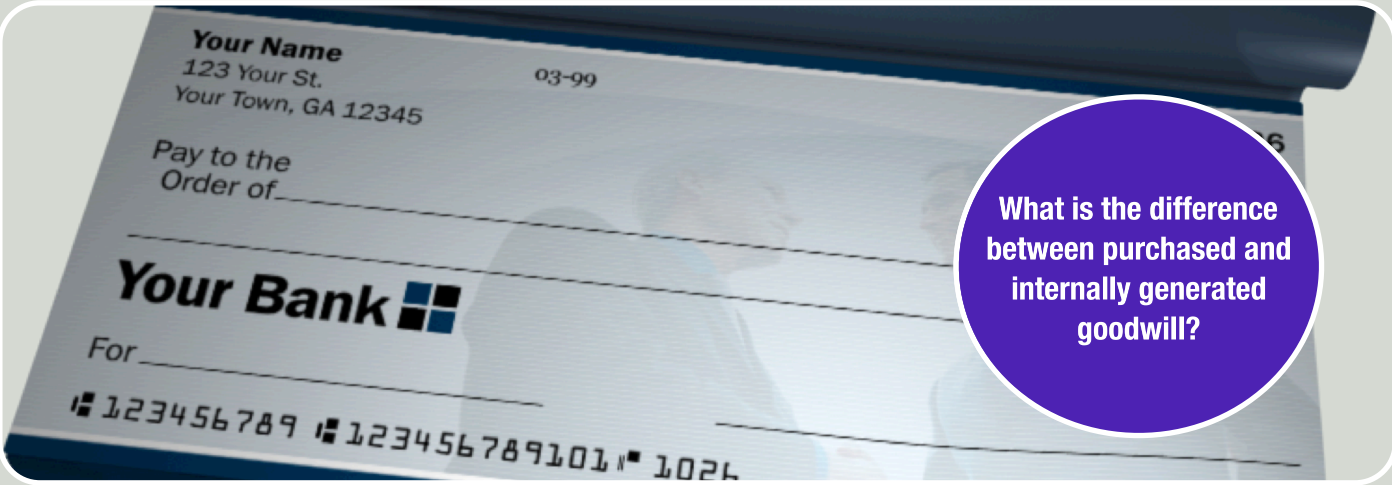
NEWSLETTER



DEMYSTIFYING GOODWILL IN FINANCIAL STATEMENTS

One item you will commonly find on the balance sheet of a public listed company is goodwill.

To many non-financially trained people, this is a confusing term.

Origins

So let's begin by first understanding the context or circumstances for goodwill to exist. In other words, when does goodwill arise?

Whenever one company buys over another company and pays a premium, a goodwill figure is calculated. This number is the direct consequence of a merger and acquisition activity.

For example, if company A pays $150 million to buy all the shares of company B, making B its subsidiary when B's net assets are worth $100 million, the difference of $50 million is goodwill (You can refer to September's newsletter to refresh your understanding on Group Structure).

The key is that it must arise from an acquisition activity resulting in a purchase of one company by another company in whole or in part.

As our example above shows, the acquiring company essentially pays for two types of assets--the net assets of the business and a premium value called goodwill.

Based on current accounting rules, the acquirer has to disclose the goodwill as a separate line. This is recorded as a non-current asset and classified as intangible, which means it does not have a physical form, unlike property, plant and equipment.

Rationale

One way that people think about goodwill is that it represents the future profits of the company.

More specifically, for a healthy and profitable company, it is expected to generate net cash flows in the future from its

"GOODWILL"

Unidentifiable, intangible asset with indefinite useful life.

operations. These future cash flow streams constitute the value of the company.

When compared to the net assets in the balance sheet, the value of the company is normally higher.

This is because a healthy company is normally worth more than the value of its net assets. The reason is that management and employees of the company, when executing the right strategy, will be able to generate more value from using the assets than through a sale of the assets.

Internally Generated Goodwill

The question you may ask is, if this is so, shouldn't every company have a goodwill figure?

The answer is yes and no.

Yes, in that it should have a goodwill number. No, in that it cannot be explicitly placed on its own balance sheet. Current accounting standards specifically bar companies from putting their internally generated goodwill on their own balance sheet.

This is because of the subjectivity involved in valuing a company's goodwill.

Hence, the goodwill you see on a balance sheet today refers only to goodwill that is purchased through the acquisition of another company.

Impairment

Purchased goodwill is subject to an annual impairment test to see if the value is worth at least what was recognised at the point of acquisition.

In the past, goodwill used to be amortised over an arbitrary useful life of not exceeding 20 years. However, much support has been given to the view that goodwill has an indefinite useful life, which may be much more or less than 20 years. Hence current accounting standards have dispensed with the need to amortise goodwill, and instead requires an impairment review.

A major impairment shortly after an acquisition could signify that the acquiring company might have been too enthusiastic in its forecast of the future potential of the company which resulted in overpayment and hence a write-off as an impairment charge.

These terms have the same meaning:

Goodwill on consolidation

Premium on acquisition

Purchased goodwill

About the author

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