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Theoretical bases on the nature of goodwill

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Abstract. Goodwill has been for over a decade a subject of debates and discussions trying to define the concept: its definition, its nature, its recognition. Indeed, the state of research witnesses to the abundant studies using different methodologies. Through this article we will try to make an overview to discuss the concept, its composition and classification. Beginning with a historical overview describing the appearance and theories related to goodwill, this article will be an overview that attempts to bring opinions and definitions given by researchers and then analyze the factors that determine the motivations of the managers of an acquiring company to pay more to the acquired firm the goodwill. In all these definitions, we present a critical opinion to obtain a theoretical and understandable basis for goodwill.
Keywords. Goodwill; Theory of goodwill; Intangible; Residue; Super profit; Managers; Agency theory; Overpayment; Performance.
JEL. G32, O34, G34, N80, O32, O38, M41, M48, H11.

1. Introduction

In an external growth environment in perpetual emergence and in the context of globalization, countries must question their value proposition. Indeed, intangible capital is a component that has taken a growing part in assessing the value of nations and businesses. Specifically, as a result of acquisitions and mergers since the 1990s, the concept of goodwill has taken considerable weight in the groups' balance sheets

Thus, in this context marked by the growth for companies and the increasing importance of the immaterial part, the share of intangible assets including goodwill, has become widely present in the balance sheets of assets ' groups. Subject of controversy for nearly a century, the problem of definition, evaluation and recognition of goodwill resulted in an abundant literature. Actually, the goodwill represents the most intangible of all intangibles (Davis, 1992).

Goodwill is, by nature, a complex object as long as it combines two main perspectives the first is economic - it is the present value of expected economic profits - the second is accounting - excess of the price paid by an acquirer on the fair value of net assets acquired. This last definition supposes an overpayment, actually, the payment of a goodwill in relation to the fair value of the tangible and intangible assets of the company is justified by motivations relating to managers but also to other economic and financial factors.

This article will not attempt to discuss the goodwill and its accounting issue or debate (Amortization-Impairment) as we believe that it is born of the ambiguity

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related to its definition and nature. Therefore, through this article we will try to make an overview to better understand the theoretical foundations related to goodwill and expose the motivations of the managers to pay more to the acquired company.

To ensure the logical sequence of the ideas in this paper, it is important to first start with presenting a historical overview of what is the goodwill and the field will be cleared to an overview of definitions proposed by the researchers, and then we will try to thoroughly describe the classifications and components of goodwill. Finally, the last section is dedicated to the reasons that justify the payment of goodwill.

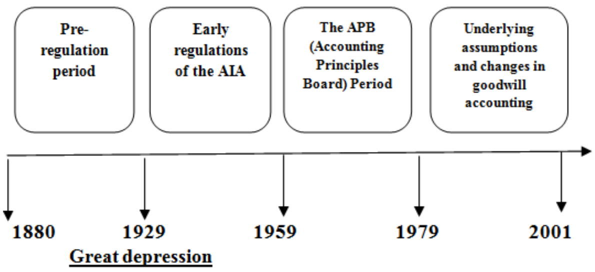
2. Conceptual framework of goodwill

2.1. Goodwill History

The concept of goodwill is not recent and dates from the 15s since it appeared with commercial relations and remains linked to economic profits.

In fact, the appearance of the journal "The Accountant" dating from 1874 testifies the beginning of the accounting literature relating to goodwill.

By the following schema we tried to sum up the chronological development of events concerning goodwill



- Pre-regulation period: 1880-1929: The beginning of the goodwill issue in accounting
- Early regulations of the AIA:1929-1959: The rise of historical cost paradigm through early AIA debates
- The APB (Accounting Principles Board) Period:1959-1979: The debates switch from goodwill's treatment to accounting for business combination in the APB
- Underlying assumptions and changes in goodwill accounting: 1979-2001: We show the partial replacement of the dominant theory of value and its consequences on goodwill's standards provided by the FASB.

2.2. Conceptions about goodwill

2.2.1. According to the nature of the goodwill

The examination of the definition of goodwill leads to the determination of its nature. Thus, Hendriksen (1982: 407) presents three conceptions related to goodwill:

- The intangible concept: It is about intangible attitudes related to the company.
- The concept of super profits: the discounted value of the excess of expected future profits over the normal remuneration of the total investment excluding goodwill;
- The concept of residue: The excess of the value of the enterprise as a whole on the valuation of its individual tangible and intangible assets.

2.2.2. According to the accounting treatment

Zanoni (2009) distinguishes between three theoretical conceptions of goodwill that are related to different accounting treatments. These can be illustrated as follows:

Table 1. *Accounting concepts and treatments for goodwill*

Conceptions of goodwill	Accounting treatment
Goodwill is not an asset	total change in charge / deduction of equity: the value of goodwill is deducted from the result or from the equity of the acquirer when the acquisition is finalized
Goodwill is a part of the investment made to control the target	*"purchase method"*: goodwill must be presented in the accounts of the acquirer as the difference between the purchase price and the fair value proquota of the assets acquired
goodwill is a generic asset, that is, a strategic asset controlled by the acquirer company following the combination	*"acquisition method"* : the accounting system of the acquirer company must show a "full goodwill" incorporating the sum of the fair values of the acquired items and the minority interests of which the fair value of the identifiable assets net of the assumed debts is deducted.

2.3. Definitions of goodwill

Firstly, it is advisable to present the definition given in IFRS3 "Business combination" which considers goodwill as an asset representing the future economic benefits resulting from other assets acquired in a business combination that are not individually identified and accounted separately.

IAS22, on the other hand, defines goodwill as "any excess of the cost of acquisition over the interest portion of the acquirer in the fair value of the identifiable assets and liabilities acquired on the date of the exchange transaction". As a result, goodwill represents the excess of the purchase price over the value of net assets in the subsidiary. In summary, goodwill is considered as the value of intangible assets that cannot be identified.

Walker (1953: 213) "By definition, goodwill has no accounting significance except in terms of an earning capacity which is estimated to be above normal. A price is paid for goodwill - a price above the value placed on the other assets - because profits in excess of a normal return on the investment is anticipated. In other words, an enterprise is purchased, not primarily as a means of securing a group of assets, but as a means of securing a stream of income in the future."

In the same manner, P.D Leake defines goodwill as the present value of expected future super profits. To put it differently, when a man pays for goodwill, he pays for something that places him in the position of being able to earn money than he would not be able to earn by his own efforts according to L.R Dicksee.

Besides, Kaner (1937): In his book (A new theory of Goodwill), evokes the need for a goodwill theory built on scientific knowledge obtained from analysis research and classification. He argues that the theory of super profit is not based on scientific approach.

Thus, Kaner distinguishes 4 ways to determine goodwill, these definitions are presented in schema below Nobes (1992): First author to conduct a study for Goodwill literature in the particular setting of UK. He insists on Cyclicity of the connection to the standards regulating goodwill. According to Marco Giuliani & Daniel Brannstrom, two perspectives about goodwill can be listed:

- *Top down perspective : (goodwill as a residuum):*

Goodwill is a leftover residual amount or part of an asset. In here, we have two opinions:

a. Goodwill exists because it's difficult to identify and measure all intangible assets in the right way. It is a convenient way for accountants who can't identify all assets of the firm or business combinations, thus, limits recorded in practice can justify the use of residual goodwill item.
b. Defining goodwill as a difference is a matter of measurement and not that of definition.

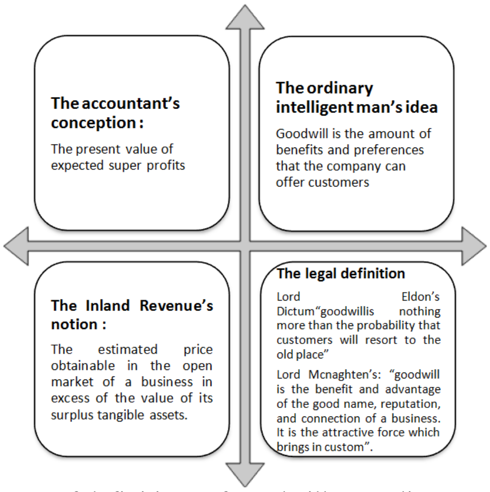


Figure 1. *Summary of definitions of goodwill according to H. Kaner (1937).*

- *Bottom-up perspective : (goodwill as a large group of intangibles)*

Goodwill is considered according to its component. Hingson defines it as being the sum of unrecognized but potentially identified intangible assets.

In the analysis of the nature of goodwill it is also important to look at the distinguishing characteristics of goodwill. A literature review has allowed to detect the following characteristics of goodwill:

- Goodwill is intangible, intrinsic to the company and cannot be sold separately from the business ;
- There is no significant even reliable link between goodwill amount and the costs of the business;
- It's difficult to identify or evaluate separately the intangible factors that are linked to goodwill;
- The value of goodwill fluctuates widely depending on internal and external factors over relatively short periods; and
- The valuation of goodwill is highly subjective as its value may differ

Catlett & Olson (1968: 21) listed the following two additional, but controversial, characteristics of goodwill:

- Goodwill is not used or consumed in the production of earnings and
- Goodwill appears to be an element of value which runs directly to the investor or owner of a business and not to the business itself.

According to Lee (1971: 322), the characteristics of goodwill can be described as follows:

- The various resources contributing to the existence of goodwill and therefore to the overall profitability of the firm may be ignored; and
- Confusion may be made between the nature of goodwill and its method of valuation.

2.4. Classification of goodwill

Several classifications of the concept of goodwill have been established, we will try to present the following main classifications proposed by researchers who were interested by giving more clarifications about the nature of goodwill:

2.4.1. Classification based on the acquisition operation:

Ratiu, Tudor Tiron in his article[1] distinguishes between three situations related to goodwill:

[1]The classification of GW an essential accounting analysis, Ratiu, Tudor Tiron.

a. *Positive purchased Goodwill:* Company acquires another one for a consideration more important than just of that of fair value of the acquired assets.

According to the paragraph 32 under IFRS 3, goodwill, as a going concern valuation, is recorded at the same time of purchase as the remaining between the excess of cost over the fair value of identifiable net assets which are acquired.

The debate around the goodwill continues still, however, professional bodies and academics agree on one thing: purchased goodwill is the only identifiable type of goodwill which can be measured at a reliable cost and which can be evaluated separately.

b. *Negative Goodwill:* The IFRS, paragraph 35 defines negative purchase goodwill as " a bargain purchase is a business combination in which the net fair value of the identifiable assets acquired and liabilities assumed exceeds the aggregate of the consideration transferred, the non-controlling interests in the acquire".

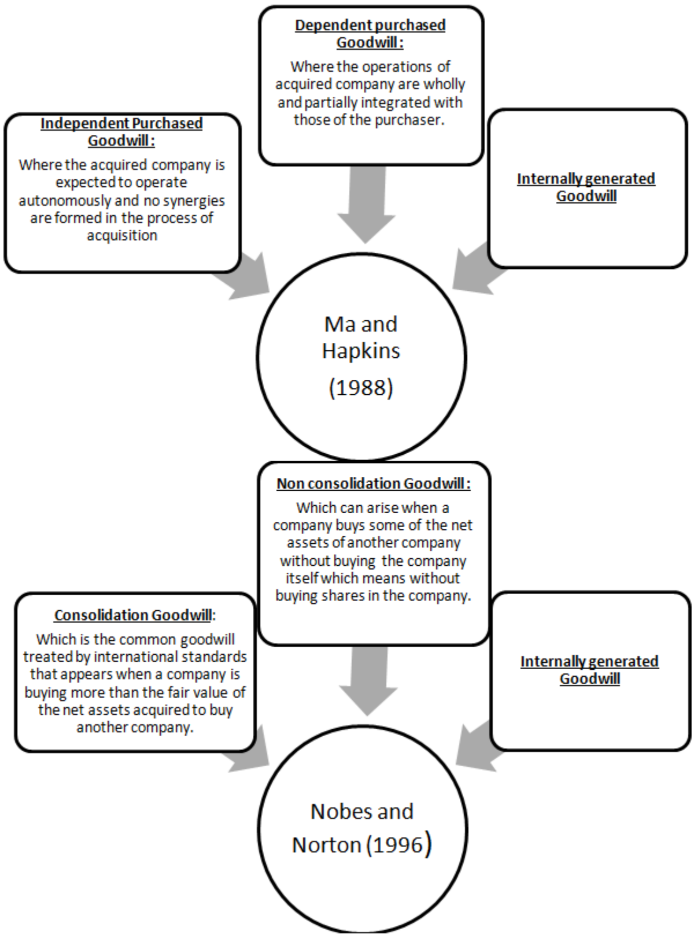


Figure 2. *Conceptions of Ma et Al and Nobes et Al about classifications of goodwill*

When a bargain purchase acquisition occurs the excess fair value of the assets acquired should be recorded in the financial statements as a gain for the current period.

The USGAAP SFA 141 "Business Combinations" adopts a similar approach in defining and accounting for NPG but in addition it stipulates that the acquirer needs to motivate and explain the reasons why the BP happened.

c. *Internally generated Goodwill:* Accounting standards worldwide have never recognized Internally generated goodwill on the balance sheets.

Walker (1838): “Accountants agree that goodwill should not be recognized in accounts until a Bona fide purchase has been made”. According to 1994 Exposure Draft on intangible assets: “goodwill is not an identifiable asset which can be measured reliably at cost”

AASB 1013”Accounting for goodwill” from 1996, stipulates that internally generated goodwill by the entity should not be recognized by the enterprise for 2 reasons:

- The inability of identifying the events or activities which lead to goodwill formation
- Within the company, the actual extent to which those events and actions generate future earnings to the company.

2.4.2. Classification based on its components:

H. Kaner in his book “A new theory of goodwill” attempts to determine the kinds of goodwill on the basis of its heterogeneous nature. It represents a black box easier to decompose but more difficult to construct. Seven types of Goodwill were analyzed by H.Kaner as follows:

- *Locality goodwill:* This type of goodwill depends on the positioning of the company and the benefits from its position. It is thus understood that his valuation could be based on rent. Such goodwill is present in certain types of commercial companies like Retail shops, occasionally wholesalers…
- *Efficiency goodwill:* The efficiency goodwill is directly linked to the performances, knowledge and skill of the director, manager, and proprietor. It leads spontaneously to an increased cost of production (wages for labor, expenses of plants and so on..) which might be a basis for valuation purpose.
- *Organization goodwill:* This type of goodwill applies to the distribution part(Good system of supplying consumers certainly and regularly,as opposed to the production side. To evaluate the organization goodwill, the extra salaries and commission paid to salesman can be used.
- *Advertisement goodwill*: It means the goodwill constructed by using advertising. It is appropriate to distinguish between cases where a stop of advertising generates lower sales and therefore affects the value of goodwill and vice versa. The cost of advertising is a direct measure of the value of goodwill in particular it is a matter of establishing the relationship of annual cost of advertising linked to the initial campaign and turnover.
- *Personal goodwill:* According to this type, goodwill is personal to the proprietor, thus, the goodwill of the business diminishes or disappears at the death of the proprietor. The personal goodwill exists in professions and industrial concerns (brilliant engineer…). To evaluate this goodwill, the fees and salaries that the person gets is used as a basis.
- *Established goodwill*: The established goodwill is linked to the habits the consumer constructs towards a certain product: “the longer the habit, the more reluctant is the change”. This goodwill is derived from what we call “regular customers”. To evaluate it, the relationship between the turnover and the number of sales for a certain period (which may give an idea of the customers retained during a giving period)
- *Monopoly goodwill:* The monopoly goodwill depends on the particular rights available to the enterprise (designs, copyrights, patents…) which gave it the monopoly . The value of the goodwill can be calculated “on the basis of the present value of the net profits for which the monopoly is responsible”.

3. State of art related to the nature of goodwill

3.1. Components of goodwill

In order to determine the value of goodwill, it is important to take into account the effect of its composition which means that a study of each element of goodwill separately and its valuation by separate methods and on different basis according to each kind are necessary for valuation purpose.

3.1.1. According to: Marco Giuliani & Daniel Brannstrom:

Actually, Marco Giuliani & Daniel Brannstrom distinguishes two components of goodwill:

- *Core goodwill*: Explanations of the interpretation of goodwill eg: Extra sales, economy of scale, profitability..
- *Intangibles*: As a matter of fact,this component gathers what the company cannot record in the financial statements like : personnel, knowledge, market position, marketing organization coupled with intangibles a company won't account for separately.

3.1.2. According to Bernard Martoryu and Françoise Verdies: Goodwill is a *heterogeneous residue:*

In fact, the residue contents non-identifiable intangible assets with an overall assessment unable to isolate and economic future net income or the appreciation of value on the basis of future net income.

3.1.3. According to Christian Pratdithauret:

Similarly, Christian Pratdithauret considers goodwill as a heterogeneous residue that consists of the following elements:

- Costs allocated to research and development activities
- The sum of the skills and resources of the firm
- Growth Options
- The estimated financial value of synergies (anticipated and valued on the basis of organizational characteristics and competitive positions acquired by companies at the date of the merger (acquisition).

3.1.4. According to Steven L. Henning Barry L. Lewis and Wayne H. Shaw

Four components of both the difference between the acquisition price and the preacquisition book value of the target firm's assets:

- *The write-up of the target firm's assets to fair market value*: Calculated as the difference between the fair market value of the target firm's assets and their preacquisition book value;
- *The value of the target as a going concern or standalone entity*: calculated as the difference between the target's preacquisition market value measured 6 days before the acquisition and the target's fair market value of assets;
- *The market's valuation of the synergetic value created by the acquisition*: calculated as the combined cumulative abnormal returns to the target and the acquirer for the 11 days centered on the acquisition announcement;
- *Any overvaluation of the consideration and/or overpayment for the target*: calculated as the purchase price less the sum of the preacquisition book value of the target's assets.

3.1.5. According to: Johnson and Petrone

Johnson & Petrone (1998) decompose the excess of purchase price minus the preacquisition target book value of assets into six components:

- *Components related to the target:*
  - The excess fair value of recognized assets over preacquisition target book values,
  - The fair value of previously unrecognized assets
  - The ability of the enterprise to earn, on a GC or standalone basis, a higher return on a collection of net assets than would be expected if those net assets were acquired separately (Johnson & Petrone, 1998).
- *Components related to the acquisition :*
  - The fair value of synergies from combining the acquirer's and target's businesses and net assets
  - Payments resulting from over(under) valuation of the consideration used
  - Over (under) payment by the acquirer in the course of bidding (Johnson & Petrone, 1998).

The study divide the excess of purchase price minus the book value of assets acquired into four components: Writeup, GC, Synergy and Resid

- ➢ Components 1 and 2 are within the Writeup and calculated as the excess of the fair values of acquired net assets over their net book values.
- ➢ Component 3 (GC goodwill) calculated as the difference between the fair value of assets recognized and the preacquisition market value of the target.
- ➢ Component 4 (Synergy) is the combined cumulative abnormal returns to the target and acquirer in the 11 day window centered on the acquisition announcement
- ➢ Component 5 and 6 (Resid) are calculated as the excess of purchased goodwill over the CG and Synergy.

3.1.6. According to Luc Paugam

According to Luc Paugam, goodwill is broken down to two elements:

- *Core goodwill*: source of future economic benefits. This element can be divided into two categories, namely:
  - o *Internally generated goodwill*: This is a goodwill realized by the company prior to the acquisition transaction. Internally generated goodwill reflects the company's ability to generate a return on assets that are affordable (Arnold *et. al.,* 1994, Johnson & Petrone, 1998: 296).
  - o *External synergies* between the acquiring and the acquired company.

The Core Goodwill is the component that allows the creation of value for the company that has the intangible assets. According to Falk & Gordon (1977) by taking advantage of existing market imperfections, the company may receive a benefit from favorable positioning and therefore create economic profits in the accounts as goodwill.

- *The overpayment*: transfer value of shareholders of the offeror to shareholders of the target. From a psychological factor, managers feel motivated about expectations of performance achieved reunification and increasingly paying the acquire.

3.2. The reasons why managers pay goodwill:

3.2.1. Information asymmetry and the role of accounting bonuses:

Information asymmetry is a problem that arises between two contracting parties, where one party holds privileged information over another party; Here we are talking particularly about asymmetry (agency theory) between investors and managers.

In order to guard against the risk of asymmetric information, companies are turning to compensation contracts to encourage managers (Healy & Palepu, 2001). On the other hand, accounting bonuses are of major interest because only some of them can be influenced by changes in accounting standards. In fact, premiums that are influenced by goodwill amortization are performance measures based on earnings and financial ratios, while non-earnings-based performance measures, such as cash flow or sales, they are not affected or less affected.

Information asymmetry is a major criterion for awarding the acquisition price as long as managers prefer the targets that will increase the well-being of management (Berkovitch & Narayanan, 1993), since the importance of accounting-based bonuses for the remuneration of a CEO is an important determinant of the share of goodwill in the purchase price according to the fair value accounting (especially after the adoption of IFRS) influenced in turn by the tangible and identifiable amortization of intangible assets (Shalev, Zhang & Zhang, 2013). However, the impairment of goodwill will have a negative impact on CEO share compensation due to negative market reactions (Li *et al.,* 2011, Bens, Heltzer & Segal 2011). As a result, managers with earnings-based compensation awards are more motivated to raise the amount of goodwill recognized after the adoption of IFRS (Detze & Zülch, 2012). In fact, the importance of remuneration based on the accounting premium is positively associated with the extent of profit management (Larcker, Richardson & Tuna, 2007).

3.2.2. Well-being in management

The motive of well-being of management represents a reason for the managers to engage in winning acquisitions. Berkovitch & Narayanan (1993) point out that, as part of the acquisition, acquirers identify the most appropriate targets to improve the well-being of the buyer's management. It is important to emphasize that the well-being of management can lead to either opportunistic management behavior or outsourcing that maximizes shareholder value. Of all the managers' incentives, only the well-being of management explains the reason why managers pay less money for targets with a significant amount of goodwill in their balance sheets. This is because prior to IFRS, goodwill amortization was likely to reduce accounting premiums. The introduction of IFRS 3 removed goodwill amortization for the goodwill impairment test, thus giving managers no excuses not to favor targets with high amounts of goodwill, and this should in turn increase the risk of goodwill impairment. premium paid for these companies.

4. Conclusion

Goodwill has long been the subject of much debate and research, until today, the subject of goodwill still arouses the curiosity of researchers to improve practice and expand on the theories related to it.

According to Hughes (1982) "The origin of goodwill can be revealed through history, but its nature is a matter of personal interpretation”. Indeed, the problem with defining goodwill remains in dealing with personal opinions of authors, moreover, the definitions given to goodwill are all based on valuation matter and not that of substance. Another problem with defining goodwill is that whether goodwill must be treated as an asset or not.

The important conclusions that we may notice are:

- Among the most cited definitions of goodwill by researchers, the concept of "super profit concept" and "residuum concept" appear. These definitions are related to goodwill assessment methods rather than the definition of its nature.
- The ability of the company to generate higher profits returns to normal assets employed has a direct impact on the value of goodwill

The consideration of goodwill as from higher profits than the returns of assets used and its decomposition into several intangible assets and according to different criteria in order better understand its nature will lead to make a better decision about the accounting treatment of this concept.

Yet, the question of Goodwill always leaves different interpretations about its definition, accounting and monitoring value after the acquisition transaction. Thus, several lines of research arise to continue on the path of understanding the concept of goodwill:

- The impact of accounting, amortization or impairment test on financial statements and the company's ability to generate cashflows.
- The changes in accounting rules and the results of the business
- The selection of alternative valuation models.

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