ACCOUNTING FOR GOODWILL

CONFUSED? TIGHTEN THE P/E ANOTHER NOTCH

by *MICHAEL BROWN*

Difficult decisions may lie ahead as companies come to grips with the ASRB's determinations on accounting for goodwill. Some areas, not quite black-and-white, may need testing before the NCSC.

The treatment of goodwill in the accounts of public companies has always provided an interesting topic for debate. On April 18, 1988, the ground rules for that debate were changed when the Approved Accounting Standard No. 18 (AAS18), "Accounting for Goodwill", was given the force of law by the Accounting Standards Review Board (ASRB).

The goodwill standard, ASRB1013, applies to all accounts dated later than June 19, 1988. The principles of the standard are:

- Goodwill is defined as the future benefits from unidentifiable assets (Clause 10)
- Purchased goodwill is defined as the excess of the cost of acquisition over the fair value of identifiable assets (Cl. 31).
- Identifiable assets include intangibles such as trademarks, patents, rights and copyrights which can be individually identified and recorded.
- To the extent that the cost of acquisitions incurred by the company exceeds the fair value of the identifiable assets acquired, but the difference does not constitute goodwill, such difference shall be charged to the profit and loss account immediately (Cl. 33).
- Purchased goodwill is to be amortised to the profit and loss account over the period of time during which the benefits are expected to arise – not exceeding 20 years (Cl. 35).
- The unamortised balance of goodwill shall be reviewed at each balance date and charged to the profit and loss account to the extent that future benefits are no longer probable (Cl. 36).
- The statutory accounts will need to disclose the following:
  — unamortised balance of goodwill;
  — amount amortised during year;
  — period over which goodwill is amortised; and
  — amortisation method (Cl. 70).
- Internally generated goodwill is not permitted to be brought to account because of the difficulty of valuation (Cl. 20).
- Where consideration for an acquisition includes shares, the market price or valuation of shares is used to determine cost.
- Cost of acquisition includes costs which directly relate to the acquisition, such as stamp duty, legal fees, etc (Cl. 10).

The amortisation of what may have previously been treated as goodwill over a period not exceeding 20 years is not the end of the story. A close examination of the principles of the standard reveals several avenues to minimise or eliminate that part of the cost of an acquisition recorded as goodwill.

First, the acquired company's tangible and intangible assets (patents, trademarks, etc) can be revalued to reduce the difference between acquisition cost and the fair value of assets acquired. In this regard, companies would be wise to interpret narrowly the definition of goodwill and therefore ascribe a value to

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every identifiable asset.

On acquisition of a company, goodwill under ASRB1013 should be calculated as the *absolute* residual after taking into account *all* economic resources purchased. That means a value should be given to all "assets" whether they were previously recorded in the books of the acquired company or not. However, the basis of valuation will need to be consistent with traditional accounting concepts.

Second, companies may use Clause 33 of ASRB1013 to charge to the profit and loss account immediately that part of the difference between the cost and fair value (i.e., premium over net assets) which does not constitute goodwill. In this regard, it is interesting to note the commentary to ASRB 1013 which includes the following:

- Goodwill is brought to account as an asset when it satisfies the following asset recognition criteria;

[a] it is probable that the future benefits embodied in the unidentifiable assets will eventuate; and

[b] it possesses a cost or other value that can be measured reliably.

Using this interpretation, it may be possible to construct a case that the excess of the cost of an acquisition over the fair value of the identifiable assets does not constitute goodwill which should be brought to account as an asset.

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The final effect of goodwill amortisation on a company's share price will be an important factor to consider for any company contemplating an acquisition.

Where goodwill is written off pursuant to Clause 1013.33, the impact on the company's profit and loss statement is confined to one year. There may also be justification for such a write-off to be included as an extraordinary item but the classification between "extraordinary" or "operating" will depend on AAS1 – "Profit and Loss Statements."

Third, companies may accelerate goodwill write-offs or utilise the maximum write-off period, depending on directors' evaluations of the period of time over which benefits are expected to arise. This will not help companies reduce goodwill but will give them some scope in determining when it is brought to account.

Finally, companies may use Section 269 of the Companies Code, which enables a company to diverge from accounting standards when the use of those standards would not give a *true and fair view* of the matters required to be dealt with in the company's accounts. Alternatively, companies may apply to the NCSC for an exemption from ASRB1013 under Section 273 of the Companies Code.

The companies which are forced to amortise goodwill above the line (and did not before) will now have a lower profit after tax and before extraordinary items ("reported profits") than would otherwise have been the case. Since the standard applies only to purchased goodwill, this will affect only companies which grow through acquisitions (where the consideration for the acquisition includes a premium over the net asset value).

The lower "accounting" earnings per share (EPS) for the affected companies will force analysts to revise their interpretation of reported EPS. The evaluation of reported EPS could make companies look less attractive, relative to companies which do not have goodwill to amortise, if the evaluation does not fully account for the goodwill element of expenses. The net result could well be a negative impact on an affected company's share price, which in turn will raise the cost of equity capital to that company. Table 4 sets out a simple example to illustrate the apparent negative effect of any acquisition which includes consideration for goodwill on a company's earnings under ASRB1013.

In Table 1 we list some companies which previously wrote off goodwill as an extraordinary item or directly against shareholders' funds, to see what the effect of compliance with ASRB1013 would have been on their reported EPS.

The final effect of goodwill amortisation on a company's share price will be an important factor to consider for any company contemplating an acquisition. For example, if we assume that price/earnings (P/E) multiples are a proxy measure of the goodwill element of an acquisition, then any negative impact on share price from goodwill amortisation could discourage companies from making acquisitions in countries where companies generally trade at high P/E multiples.

To illustrate the importance of this concept, the average historical industrial P/E multiples for various countries at June 30, 1988, are set out in Table 2.

The potential problems associated with ASRB1013 may all be traced back to the lack of comparability of reported EPS between companies with different amounts of goodwill in their balance

Table 1: Effect of compliance with ASRB goodwill standard

	Reported EPS	*Adjusted EPS**	*Year ended*
Pacific Dunlop	28.3	27.9	30 June 1987
Burns Philp	28.9	27.1	30 June 1987
Boral	33.3	30.8	30 June 1987
Coles-Myer	48.2	47.2	26 July 1987
James Hardie	29.6	28.1	31 March 1988

*Reported EPS adjusted to reflect the impact of annual goodwill amortisation over 20 years.

sheets. The extreme case is the comparison of a company with a large amount of purchased goodwill in its balance sheet with a company which has grown and developed its goodwill internally.

Analysts will always record and forecast reported earnings and can be expected to account for any reduction in EPS due to goodwill amortisation when determining the P/E multiple to apply to a particular stock.

However, the question is whether or not analysts will *accurately* adjust P/E multiples to reflect any amortisation of goodwill. The goodwill impact on profits will, at best, confuse the market about appropriate multiples to apply to affected shares and, at worst, be ignored by the market and not taken into account at all.

If companies whose earnings are reduced by amortisation of acquired goodwill have the same P/E multiples as companies which have internally generated goodwill (which is not required to be amortised against earnings), then clearly the company which acquires goodwill will be disadvantaged.

It is also interesting to note the treatment of goodwill in other countries:

- United Kingdom – companies may elect to write off or amortise goodwill over the economic life of the asset.
- Japan – goodwill is amortised within a five-year period.
- US and Canada – goodwill is amortised to income over the estimated life of such goodwill, but not exceeding 40 years.

Clearly there is also a lack of comparability between companies across international boundaries.

To minimise the required goodwill write-off, some companies have sought independent valuations of intangible assets acquired, such as trademarks, patents, etc, and revalued these items in

Table 2: Average historic P/E multiples at June 30, 1988

Country	*P/E*
Australia	15
United Kingdom	13
United States	22
Japan	95

Table 3: NCSC exemptions

Company	*Goodwill written off ($m)*
North Broken Hill	408
Coles-Myer	313
Girvan Corporation	216
Pacific Dunlop	85

the accounts. These items are unlikely to be amortised.

Other companies have been granted exemption from amortising goodwill by the NCSC under Section 273 of the Companies Code. The NCSC's rationale for allowing the departure was not to prejudice companies which had made acquisitions before the introduction of the new standard on April 18 this year; the exemption lasts for only one year. The companies which have sought and been granted exemptions and written off large amounts of goodwill include those in Table 3.

Mojo MDA also applied to the NCSC for an exemption from ASRB1013. However, the exemption was denied. Consequently, Mojo has disclosed a $42 million extraordinary loss flowing almost entirely from a decision to write off accumulated goodwill.

Mojo has been expanding and much of this expansion has come through acquisitions. Mojo is a services (advertising) company and therefore its acquisitions have primarily been acquisitions of intangibles, much of which is classified as goodwill. The inclusion of amortisation of goodwill in its profit and loss account was considered by Mojo not to have given a *true and fair* value for

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earnings. Therefore, Mojo relied on Section 269 of the Companies Code for non-compliance with ASRB1013. If Mojo had complied with the standard and written off the minimum amount of goodwill allowed, it would have reduced its reported earnings by 44 per cent. That is, instead of reporting a profit after tax of $4.9 million, it would have reported only $2.8 million.

The auditors for Mojo did qualify this treatment of goodwill as not being in accordance with the standards but also commented that they did not disagree with the approach taken by Mojo.

Another company to write off goodwill in its June 1988 accounts is Burns Philp, which has written off goodwill in accordance with ASRB1013 Clause 33. That is, Burns Philp has claimed that the excess of the cost of acquisitions over the fair value of identifiable assets does not fall within the ambit of goodwill discussed earlier. The reasoning used by Burns Philip is that the acquisition premium they have paid does not constitute goodwill for which clearly identifiable benefits exist. This treatment of goodwill was not qualified by Burns Philp's auditors.

Conclusion

The new goodwill standard, ASRB1013, will reduce reported EPS for companies growing through acquisition where where part of the cost of the acquisition is recorded as goodwill. Hence, the market will be forced to adjust P/E multiples to value companies which amortise goodwill.

This in itself may confuse the market. However, where the real problem arises is that the same standard will not apply to companies which have internally generated goodwill. The reduced reported EPS of companies that have acquired goodwill may have a negative impact on those companies' share prices

and hence increase the cost of equity capital to the companies. In turn, this will disadvantage these companies when competing with similar companies who have internally generated goodwill.

The industries where this problem will be most noticed are those dominated by companies which tend to be priced at a substantial premium to their net tangible assets, such as service industries.

We are not advocating that the same standard be applied to companies which have internally generated goodwill – mainly because of the difficulty of valuing the goodwill. However, it is essential that companies report earnings on a comparable basis, which is contrary to the spirit of ASRB1013.

Another effect of ASRB1013 could be to inhibit companies looking to expand internationally through overseas acquisitions since these acquisitions are often priced at high P/E multiples implying a large goodwill component. It should be remembered that there are several Australian companies for which it is logical and even necessary to expand overseas, if they are to expand at all, since there are trade practice restrictions on the limit of expansion allowed in Australia, as well as the limiting factor of the absolute size of the Australian market. Surely we should be trying to encourage these companies to expand internationally.

The number of applications to the NCSC for exemption from complying with ASRB1013 illustrates the concern of companies that will be affected by the new standard. In later years, when these exemptions are not likely to be as forthcoming from the NCSC, companies can be expected to examine closely the various methods of minimising or eliminating goodwill. Of particular interest in this regard will be the reaction of the NCSC to the various goodwill treatment by companies in their June 30, 1988, accounts. □

Table 4: Accounting for goodwill

Set out below is an example of the apparent negative affect of an acquisition on a company's earnings under the new goodwill accounting standards. For simplicity the example ignores taxation and any synergy benefits (or costs).

Details of Company X —

Shares on issue	50 million
Profit	$10 million
Net assets	$80 million
Net tangible assets (NTA)	$80 million
EPS	$0.20
Assumed PER	10x
Share price	$2.00

Details of Company Y —

Shares on issue	50 million
Profit	$10 million
Net assets	$80 million
NTA	$80 million
EPS	$0.20
Assumed PER	10x
Share price	$2.00

Company X acquires 100% of Company Y for consideration of one Company X share for each Company Y share, i.e. the effective consideration is 50 million shares x $2.00 – $100 million comprising $80 million for payment of net assets plus $20 million goodwill.

Details of the merged Company XY —

Shares on issue	100 million
Profit before goodwill write-off or amortisation	$20 million
NTA	$160 million
Goodwill on acquisition of Company Y	$20 million
Net assets	$180 million

(a) If the goodwill is written off as an extraordinary item then the reported profit before extraordinaries for the merged company will remain at $20 million giving the following —

Net assets	$160 millions
NTA	$160 million
Reported profit (before extraordinaries)	$20 million
EPS	$0.20
Assumed PER	10x
Share price	$2.00

N.B. If goodwill is written off in one year, instead of being amortised, it will reduce retained profits accordingly and hence retained earnings: i.e., there will be a negative impact on shareholders' funds.

(b) However, pursuant to ASRB1013, the goodwill would have to be amortised over 20 years and deducted from reported profit as indicated below —

Net assets before goodwill amortisation	$180 million
Profit before goodwill amortisation	$20 million
Amortisation of goodwill	$1 million
Net assets	$179 million
NTA (Net assets less the goodwill component of net assets)	$160 million
Reported profit	$19 million
EPS	$0.19
Assumed PER	10x
Share price	$1.90

The net effect of the above scenario is a 5 per cent reduction in the share price due to an "accounting illusion". Of course, *ceteris paribus*, Company XY is worth $2.00 per share given the above facts on Company X and Company Y before the merger.

The caveat in the above example is that the market will apply the same multiple to Company XY as it did to Company Y before the merger.

INSTITUTE QUESTIONS STANDARD

The Securities Institute last month circulated to members a questionnaire seeking opinions about the new goodwill accounting standards.

The Institute's letter said it was concerned that the standard could disadvantage companies which grow through acquisition, so there were implications for market pricing. The Institute wanted to assess how widespread this concern was among members.

The questionnaire asked the following:

- Do you find the proposed treatment of goodwill (amortised above the line) results in the true reflection of the operating profit of a business entity?
- Do you find the proposed treatment detracts from the comparability of accounting information (i.e., between companies)?
- How would you prefer to see goodwill treated? The question gave these seven choices of answer, with an invitation to nominate up to three in order of priority: • Amortised above the line as an operating item as per the current accounting standard. • Amortised below the line as an extraordinary item. • Written off, in one lump, above the line. • Written off, in one lump, below the line as an extraordinary item. • Left on balance sheet and not amortised. • Written off directly to reserves/shareholders' funds (i.e., not through the profit and loss account). • Companies elect to write off in one lump or amortise below the line.

The Institute intends to advise members of the result of the survey. If appropriate, the Institute will petition the NCSC, the Ministerial Council and the Accounting Standards Board to have the standard repealed.

"We have adopted this approach in the deliberate attempt to ensure that accounting standards are drawn up with the aim of meeting the needs of users of accounting information," the letter said. □