BLOG

Goodwill – a fantasy asset

Fawas Ahamed and Thanusha Rajapakshe

Goodwill is one of the most subjective plug assets on the balance sheets of companies adopting a roll-up growth strategy. Goodwill impairments directly impact EPS and share prices. Given that there are many techniques of delaying or avoiding goodwill impairment, investors need to be extremely cautious of so-called management impairment tests.

In accounting, at acquisition, an asset named "goodwill" is recognised on any premium or overpayment against the fair value of the assets and liabilities acquired, while a gain/income named "negative goodwill"(or gain on bargain purchase) is recognised on any underpayment against the fair value of the assets and liabilities acquired. This in itself is contradictory and goes against the fundamental prudence principle. If the payment is less than the fair value of net assets, you have an income; so, if you pay more, should you not have an expense? The recognition of goodwill as an asset instead of as an expense is based on the presumption that it will supposedly bring in additional economic benefits. So, if a payment more than the fair value is justified as a goodwill asset, should not a payment less than the fair value result in a liability? Even though instances in which negative goodwill arises are rare, the accounting standard requires that before recognising a gain on a bargain purchase, it has to be reassessed whether all assets and liabilities have been correctly recognised. However, if a company is able to recognise such a gain, would it really act so uprightly as to reassess it? Our view is that if a company is being sold cheap (i.e., at less than the fair value of its net assets), we need to be realistic in understanding that unless it was a forced sale, there will always be a catch. The chances are that some liability is likely to have been left off-balance-sheet or the fair values of assets are unrealistic.

Even though there is a clear logic and methodology to accounting for goodwill and testing it for impairment, this merely compounds the issue, as companies are allowed to assign goodwill to cash-generating reporting units, and test it based on the smallest cash-generating unit. This is another loophole in accounting standards, where companies can avoid goodwill impairment by allocating it to cash-generating units that are sometimes never the smallest. If it were the smallest, the entity that was acquired probably should be tested on its own. Instead, companies simply club the acquired entity with a segment and test the segment as a whole, making the entire goodwill-impairment exercise futile. Companies also allocate goodwill to cash-generating units that are expected to benefit from the acquisition; this is often a free pass to spread the goodwill thin over many cash-generating units that may not be connected to the acquisition, complicating the entire goodwill-impairment process. This leads to situations where acquired entities report deteriorating performance but the goodwill recognised on acquisition is left unimpaired. However, there are also genuine instances where a reorganisation and/or restructuring takes place after acquisition and, therefore, the unit is no longer the smallest cash-generating unit.

General Electric took a substantial goodwill-impairment hit of USD22.1bnin 2018, most of which related to its Alstom acquisition. When General Electric acquired Alstom in 2015, it recognised preliminary goodwill of USD13.5bn and revised it upwards to USD17.3bn a year later on the premise of significant cost and growth synergies. With increased M&A activity, US companies added USD386bn of goodwill to their balance sheets and had USD78.9bn of goodwill impairments in 2018 (of which USD22.1bn related to General Electric),according to the 2019 US Goodwill Impairment Study (2019 Study) by Duff & Phelps released on 3 December 2019. The report highlights that goodwill impairments have steadily increased over the years. Increasing goodwill impairments highlight the subjectivity around this fallacy asset.

How Acuity Knowledge Partners can help

It is our job to point out acquisitions that are performing below expectations and the possible impairment of intangibles and goodwill that may be hidden within the accounting rules in the forensic analysis due diligence work we undertake for asset managers. We have a team of analysts with specialist accounting skills supporting asset managers in conducting quality-of-earnings reviews with a focus on potential financial manipulations. We also conduct reviews and assessments of revenue recognition and other accounting policies.

Sources:

- International Accounting Standards Board (IASB)
- US Goodwill Impairment Study (2019 Study) by Duff & Phelps