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Recognition and measurement of purchased goodwill and usefulness of financial statements (summary)

Financial accounting is a convention, a set of principles and procedures which enable to reflect the consequences of economic transactions in the books of entities and finally their presentation in the financial statements. There are three elements which distinguish financial accounting. First of all it is a clearly defined scope of regulation. By providing the key definitions of assets, liabilities, incomes and expenses it can be easily indicated where the area of interest of financial accounting begins and ends. Secondly it is the logic of developing new regulation. In order to ensure consistency all detailed provisions should be based on general, fundamental ideas which have their source in the Conceptual Framework for Financial Reporting. Finally it is the language of money and the attempt to reflect reality by attaching value to transactions and resources.

Detailed analysis of the three features enables us to also understand the limitations of financial accounting, which make it related to social sciences than experimental sciences like biology or chemistry. The issue of goodwill appears to be one of the best illustrations of the described dilemmas. There is no other, equally controversial asset, which recognition and measurement would differ so much form other resources of an entity. In the economic sense goodwill is considered to represent all the resources which despite having „soft" and intangible nature may have a key impact on survival of the business. Usually its scope includes: knowledge and experience of the employees, good relationships with suppliers, faithful customers, market share, brand recognition, effective distribution network and others. Those factors may be vital for market success but fail to meet accounting criteria for recognition, as they individually do not meet the asset definition and consequently must not be presented in the statement of financial position of an entity.

IFRS 3 „Business combinations" defines goodwill as future economic benefits resulting from resources which cannot be attached any specific assets. Accounting theory distinguishes between two types of goodwill:

1) arising on acquisition of another business unit as the difference between purchase price and fair value of identifiable net assets of the acquiree),

2) internally generated by an entity which makes it close to colloquial meaning of the word and representing „good name", market recognition built by the long presence on a particular market.

The main aim of the work was to prove that purchase goodwill, which detailed accounting regulation can be found in IFRS 3, does not meet all the basic criteria set in the Conceptual Framework which allow to classify an item as an asset and present it in financial statements. Consequently there is a need for an alternative regulation which would be more coherent with key accounting definitions and recognition criteria.

Scope of the work covered:

1. Presenting the evolution of the economic role and definition of goodwill as a resource of an entity as well as explaining changes to its measurement and presentation which took place over the past century in the four chosen countries (Poland, UK, USA, Germany).
2. Comparing the principles for recognition, valuation and disclosure of goodwill in the five sources of accounting regulation (IFRS, Polish GAAP, UK GAAP, US GAAP, Handelsgesetzbuch) followed by explaining implications resulting from those differences in the context of usefulness and comparability of information disclosed in financial statements.
3. Analysing IFRS 3 and IAS 38 in order to verify their consistency with the Conceptual Framework in terms of recognition, measurement and presentation of goodwill.
4. Analysing financial statements of listed entities in the four countries to establish materiality of goodwill, its share in the consolidated assets, amount of its write – offs in comparison to balance sheet and income statement totals, relationships between impairment of goodwill and operating cashflows and useful life of tangible non-current assets. Thorough interpretation of results was the basis for conclusions.
5. Developing an alternative model for recognition, measurement and presentation of goodwill, which would be more coherent with fundamental accounting definitions and would contribute to enhancing usefulness of information provided in financial statements.

Key findings of the work include:

1. Changes to the accounting treatment of goodwill were often of fundamental nature and were as a rule adopted prospectively which ha dan adverse effect on comparability of information over time and between business units. In author`s opinion such discrepancies could be traced to insufficient understanding what the asset actually represents.
2. Regulation for recognition, measurement and presentation of goodwill as per IFRS 3, Polish GAAP, UK GAAP, US GAAP, Handelsgesetzbuch are areas of significant differences which impacts usefulness of data available for readers of financial statements.

3. IFRS 3 „Business combinations" is not coherent with the Conceptual Framework for financial reporting and IAS 38 „Intangible assets".

4. Present regulations of IFRS 3 regarding recognition and measurement of goodwill result in „protection" of this balance sheet item by transferring it from one accounting period to another accounting period without changing its value. This phenomenon was defined by the author as goodwill rollover.

5. Approach based on linking „rights to subsidiaries" (balance sheet category which would in the proposed model substitute goodwill) with planned and actual cashflows from operating activities as well as depreciation of tangible non-current assets of the CGU would ensure better consistency of the item in the light of Conceptual Framework and enhance usefulness of information provided in financial statements.

In author`s opinion the proposed model of „rights to subsidiaries" enables to great extend to eliminate practical weaknesses and limitations of existing regulation. This is made possible by providing strong reference between economic essence of the item with general and fundamental accounting concepts. Conceptual precision and narrowing the scope of goodwill (based on the new model called „rights to subsidiaries"), restoring amortization, linking impairment write – offs to actual rather than forecasted figures should eliminate the goodwill rollover and reinforce users confidence users in this category. In practical terms this should lead to:

- lower numbers capitalized in the statements of financial position,
- accelerated rotation of the item.

In conclusion, the work has proven that the existing accounting regulation regarding goodwill is not consistent with asset definition and other fundamental principles. Therefore the item in its present form should not be capitalised in financial statements. In order to improve usefulness of financial statements changes are necessary. Recommended direction has been presented by the author.