

Goodwill Reporting Internationally



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1. Introduction

The recent issue of revised accounting standards for business combinations under USGAAP (SFAS14R) and IFRS (IFRS3R) has been a significant step down the road to convergence. One of the most interesting changes has been the adoption by the Financial Accounting Standards Board, in the US, of the IFRS requirement for acquiring companies to disclose and explain the nature of the goodwill arising from the purchase price allocation. SFAS14R will require acquirers to disclose “a qualitative description of the factors that make up the goodwill recognized.”(1) . It goes on to suggest that these might include expected synergies and intangible assets that do not qualify for separate recognition.

The new USGAAP requirement remains noticeably weaker than the IFRS3 equivalent which is for “a description of the factors that contributed to a cost that results in the recognition of goodwill –a description of each intangible asset that was not recognised separately from goodwill and an explanation of why the intangible asset’s fair value could not be measured reliably –or a description of the nature of the excess recognised in profit or loss” .(2)

Given that goodwill is usually a significant part of the total purchase price and often the largest component, it is right that stakeholders should be told what it represents but two doubts remain as to whether IFRS3 (R) and SFAS141R go far enough. Is a qualitative description, along the lines required in the revised standards, adequate for stakeholders’ needs? And secondly, what happens if companies fail even to comply with this simple disclosure requirement?

This report analyses in more depth what can be done in analysing goodwill.

[1] SFAS141R paragraph 68e

[2] IFRS 3, Disclosure 66 (h)

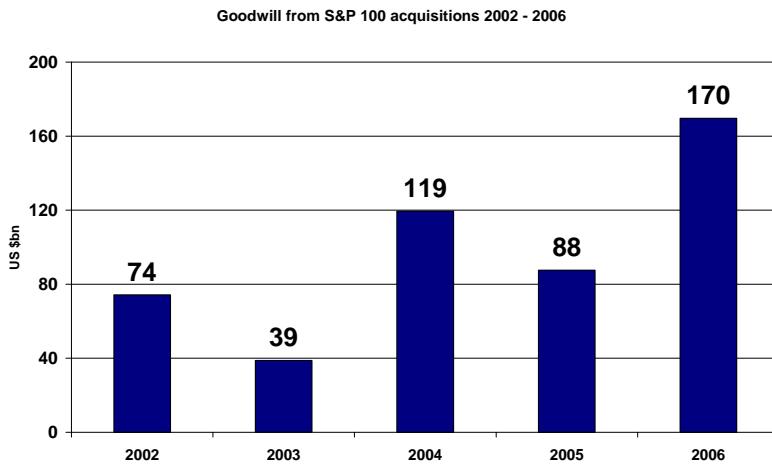


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2. Size of goodwill

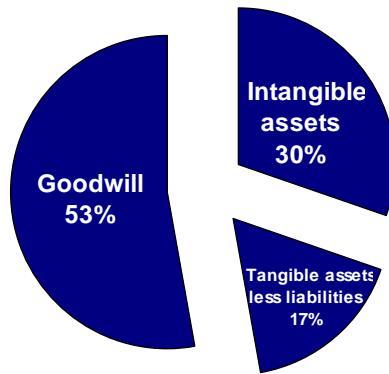
Over the first five years of application of the original SFAS141 standard on business combinations from 2002, the S&P100 companies in the US racked up acquisitions costing in excess of one trillion dollars, of which \$490 billion (47%) was allocated to goodwill. Proctor & Gamble spent \$53 billion on Gillette, of which \$35 billion was goodwill. When Bank of America bought MBNA, \$20 billion of the total price of \$35 billion went to goodwill. It seems self-evident that stakeholders should be adequately informed about these major investments of company funds.

“...\$490bn was allocated to goodwill from 2002 to 2006 following acquisitions made by the S&P 100”



Goodwill in the UK too, accounts for a significant portion of acquisitions. In the first year under IFRS3, goodwill accounted for 53% of acquisition value, or £21bn.

Figure 1 - FTSE 100 IFRS Purchase price allocation



“...FTSE 100 companies allocated £21bn to goodwill in 2006”



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3. Examples of qualitative descriptions

On the face of it a regurgitation of the words in either standard would give the appearance of compliance with the letter of the standards. "Goodwill represents expected synergies from the merger of operations and intangible assets that do not qualify for separate recognition". Here you have a standard paragraph that can be inserted into any acquiring company's annual report or 10-K that will make it look like it complies with the accounting standards and, in all probability, be true. However, such disclosure does not comply with the substance of the standards. Already in European companies and others preparing financial statements under IFRS, we see disclosures of this level of superficiality.



Mittal Steel

In its 2006 annual report Mittal Steel Company discloses details of the acquisition of Arcelor for €29 billion, of which €6 billion was allocated to goodwill. In addition Mittal completed two earlier acquisitions in 2005 for a total of €8 billion, including €1 billion of goodwill. One note covers all three acquisitions and states that "Goodwill recorded in connection with the above acquisitions is primarily attributable to the assembled workforces of the acquired businesses and the synergies expected to arise after the Company's acquisition of those businesses. (3) Granted these acquired businesses are similar, as they are all steel producers, but is a generic disclosure that does little more than repeat the wording in IFRS3 really adequate to explain to stakeholders what €7 billion was spent on?



Vodafone

In May 2006 Vodafone acquired Telsim Mobil in Turkey for £2.6 billion and the note in the 2007 Annual Report explains that the goodwill of £1.6 billion "is attributable to the expected profitability of the acquired business and the synergies expected to arise...".(4) The first part of this explanation is entirely meaningless because the, presumably intangible, assets that drive the profitability are not identified even qualitatively. Might the profitability drivers have something to do with Telsim's customers and/or its brand? These intangible assets can, of course, be valued instead of being left in goodwill. £2.6 billion is small change to Vodafone but they do, as the saying goes, "have form" when it comes to goodwill. The goodwill impairment write-offs following the Mannesmann acquisition in 2000 totalled £34.6 billion at the last count.(5)

[3] Mittal Steel Company NV Statutory Financial Statements 2006 note 3, page 51- 54

[4] Vodafone 2007 Annual Report note 28, page 130

[5] Vodafone 2007 Annual Report note 10, page 109 – impairment re Germany & Italy £23.0 billion in 2006, £11.6 billion in 2007



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eBay

When eBay bought Skype in 2005 they allocated \$2.4 billion of the total purchase price of \$2.6 billion to goodwill.^[6] If SFAS141R had been in force at that time, we would doubtless have seen some bland disclosure about the synergies and workforce. But such a disclosure would have done nothing to warn stakeholders that the goodwill on the Skype acquisition would be impaired to the tune of \$1.4 billion by the third quarter of 2007.^[7] The underlying reason for the impairment appears to be that eBay management had no strategy to exploit Skype's undoubted popularity and drive revenues. Skype was, and remains, a largely free service for most of its users and, unlike Google or Yahoo, has not been able to generate revenues through paid advertisements.

It may be too much to hope that an arcane accounting disclosure requirement might protect stakeholders from poor company managements but stronger disclosure requirements and a requirement to quantify, at least in broad terms, and have audited, the components of goodwill would bring improvements in information for stakeholders to assess for themselves significant business investments.

Quantification brings a discipline to the acquisition process and management, knowing that their estimates would be subject to audit scrutiny, might be dissuaded from repeating some of the excesses of the past. Such a process would be effective even if the quantification of the components of goodwill did not have to be disclosed in the annual report itself.

[6] eBay 10-K 2005, note 3, page 92

[7] eBay Earnings Release Q3 2007 – Other selected financial results



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4. Examples of non-compliance

It is depressing how many large companies decide that the present, decidedly unchallenging, requirements of IFRS3 for disclosure of the components of goodwill are all too much, and choose to remain silent, with the acquiescence of their auditors. For example, the acquisition of Allied Domecq by Pernod Ricard in July 2005 cost around €15 billion of which €3 billion was allocated to goodwill.



The relevant note in the annual report (8) starts encouragingly, apparently with a calculation of the goodwill. In fact it is nothing of the kind. The calculation is of the difference between the fair values of the net assets acquired and the total purchase consideration. This may seem like a matter of semantics but company management need to be able to calculate the fair value of the goodwill in order to arrive at an acceptable purchase price. Starting with the price necessary to achieve the deal, and then calculating the goodwill as the balancing figure may lead to overpayment. Not only did they not calculate the value of goodwill, they failed to mention what the goodwill comprises at all.

In fact, Pernod did probably not overpay. The synergies available to them through combining of production facilities and additional distribution and market power from the combined brand portfolios would be very valuable. They could even have told stakeholders how clever they were, getting the deal at a bargain price because the goodwill elements were worth more than they had to pay for them.

There are numerous other examples of a complete disregard of the requirement to disclose the components of goodwill. Alcatel allocated €8 billion to goodwill on the acquisition of Lucent in April 2006 (9). In the year to September 2007, Siemens completed two major acquisitions at a combined cost of €7 billion, of which close to €5 billion was allocated to goodwill.(10) In neither case, did the acquirer make any effort to explain what the goodwill represented. In 2006, Nestlé were equally dismissive of the requirement to describe CHF2.6 billion of acquired goodwill,(11) but by 2007 they had at least identified synergies, complimentary market share and competitive position as elements of acquisition goodwill of €6.9 billion in that year. (12)



[8] Pernod Ricard Annual Report 2005/06 Note 8, page 187

[9] Alcatel-Lucent reference document 2006, note 3, page 98

[10] Siemens Notes to the consolidated financial statements September 2007, note 4 page 226

[11] Nestlé Consolidated financial statements for 2006 note 27, page 65

[12] Nestlé Consolidated financial statements for 2007 note 23, page 68



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5. Defining goodwill

One of the reasons often given to why goodwill has not been described is that it cannot be done or is too difficult. This is not the case. The following are examples of what goodwill is comprised of and how to place a value on it and describe it.

Intangible assets not valued

There are unlikely to be intangible assets which do not meet the recognition criteria stipulated in FASB 141 (R) and IFRS 3 (R). However, if there are such assets they should be allocated to goodwill. The standards require them to be disclosed and reasons given why they have not been valued.

Workforce in place

The standards prohibit the valuation of workforce as an identifiable intangible asset, therefore if one has any value it should be included within goodwill.

Cost synergies

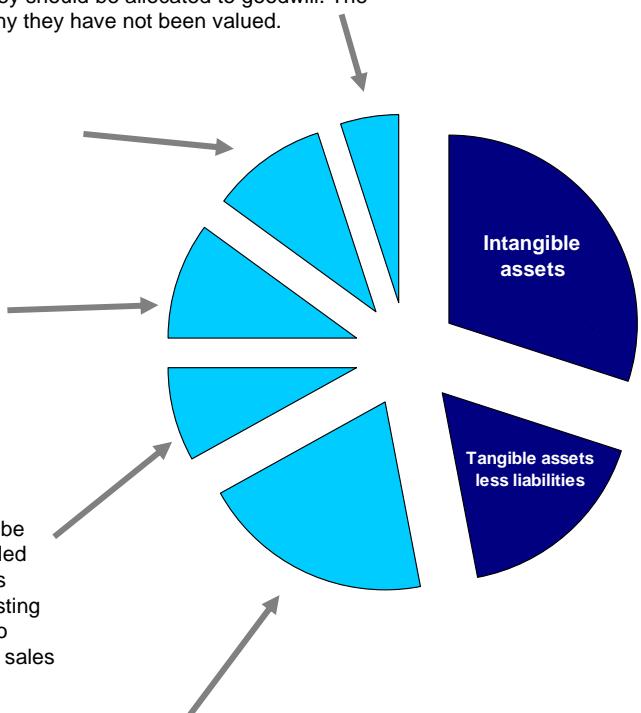
Economy of scale creates significant cost synergies when businesses combine. This can be rigorously quantified and is often a key motivation for the acquisition. For example, a saving of annual head office costs might be quantified at £5m a year, equating to a capital value of £50m. Unit costs can also be greatly reduced through increased purchasing power, creating further cost synergies.

Sales synergies

Cross-selling opportunities create sales synergies which can be quantified. For example, Aviva's acquisition of the RAC enabled Aviva to sell RAC services to its existing customers as well as being able to sell Aviva's products and services to RAC's existing customers. The portfolio effect can also be created where two powerful portfolios combine, facilitating an increase in overall sales because of their combined attraction.

Value added by buyer

The value of a business is often greater than the sum of the individual components. This value increase is quantifiable and should be allocated to goodwill and described. Of course the reverse is true as well. Our research has seen no such analysis describing such underlying value attributed to goodwill.





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6. Conclusion

IFRS3 disclosure requirement on the components of goodwill can be useful for stakeholders if properly applied. USGAAP is still some way short of even this level of disclosure and, most disturbingly, compliance frequently consists of "going through the motions" and sometimes doesn't happen at all.

Auditors seem unwilling to make an issue of this, and perhaps this is because compliance still results in such woolly, 'boiler plate' type statements. The attitude seems to be that if disclosure requirements are considered to be bland and uninformative, it doesn't matter if they are overlooked altogether. We note that the Financial Reporting Review Panel has picked up on the issue in its 2007 Annual Report.

There is a strong case for quantification and explanation of the components of goodwill, audited on a 'broad brush' basis to demonstrate that the numbers do at least add up in principle on the acquisition, based on a set of well thought out, reasonable, assumptions about the future of the combined entities. If a company cannot do it easily how can the acquisition be justified? Even if the quantification was not required to be disclosed, the fact that the calculations had been made and reviewed by auditors would increase confidence and give company managers pause for thought when negotiating deals. The information would enable disclosure of key elements.

Intangible Business

Intangible Business is the world's largest independent brand valuation consultancy, specialising in valuing intangible assets, such as brands, for financial, management and litigation purposes.

For further information and enquiries, please contact Thayne Forbes:

Intangible Business Ltd.
9 Maltings Place
169 Tower Bridge Road
London SE1 3JB

Tel: + 44 (0) 870 240 7386
Fax: +44 (0) 20 7089 9239