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Bubble of Goodwill -- A Brief Analysis of the Problems of Measurement of Goodwill

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Abstract. *The development of economic globalization and the intensification of competition have set off a new round of merger and acquisition boom in China, and at the same time brought the phenomenon of double high goodwill recognition and impairment loss of listed companies. From this background, this paper briefly analyzes the problems existing in the measurement of goodwill in China from two aspects: the initial recognition of goodwill and the measurement of goodwill impairment. In the initial recognition of goodwill, there are some problems in the recognition method and scope. In the measurement of goodwill impairment, there are some problems about how to measure and count the impairment loss. The countermeasures and Suggestions for the initial recognition of goodwill and the measurement of impairment were proposed.*

Keywords: *consolidated goodwill, initial recognition of goodwill, goodwill impairment*

1. Introduction

1.1 Research background

In recent years, with the development of economic globalization and the intensification of the competitive situation, the domestic economic growth rate has declined, and the endogenous development of enterprises has been hindered. They have turned to seek exogenous mergers and acquisitions. China has set off a new round of mergers and acquisitions. Some listed companies have used mergers and acquisitions. The method has been developed rapidly in a short period of time, and has even achieved doubled scale expansion. Through mergers and acquisitions and reorganization of enterprises, they can quickly scale up, play a synergistic effect, strengthen the enterprise's control over the market, or quickly enter a new field at a lower cost, and maintain the ability of the enterprise to continue to grow. However, a large number of listed companies have acquired high valuations and high premiums, resulting in the rapid accumulation of company goodwill. At the same time, with the rapid increase in the total amount of goodwill, it has become the norm

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to increase the amount of goodwill impairment reserves at the end of each year and to recognize high impairment losses on goodwill. Since 2014, the number of listed companies with confirmed goodwill impairment losses and the total confirmed goodwill impairment losses have shown a double increase. After landing on the GEM in 2010, BlueFocus (300058) has grown from a public relations company with only more than 300 million yuan in revenue to a large-scale communication group company with annual revenue of more than 15 billion yuan (December 2017); some are also listed The company has carried out multiple mergers and acquisitions in a short period of time. For example, Fosun Pharma (600196) has averaged 6 mergers and acquisitions each year since 2004. However, a large number of high valuation and high premium acquisitions by listed companies have led to the rapid accumulation of the company's goodwill scale. According to statistics disclosed in the annual report, as of December 31, 2017, the cumulative total of goodwill in Shanghai and Shenzhen has exceeded 1.3 trillion yuan, accounting for the proportion of net assets of these listed companies is as high as 5.22% (Table 1).

Table 1 Companies with goodwill in Shanghai and Shenzhen stock markets and their accumulated goodwill amounts from 2014-2017

Item	2014	2015	2016	2017
Number of companies	1285	1602	1781	1916
Net goodwill/100 million yuan	3291	6527	10519	13020
Attributable shareholders' equity/100 million yuan	230192	178870	217103	249610
Goodwill vs. shareholders' equity ratio/%	1.43	3.65	4.85	5.22

As of the end of 2017, 120 listed companies in my country accounted for more than 50% of their net assets at the end of the period. The end-of-term goodwill balance of 13 listed companies even exceeded the company's net assets. The company with the largest at 41.934 billion yuan, Midea Group, Weichai Power, Ping an of China and Qingdao Haier followed closely behind. Among them, goodwill accounted for the largest proportion of net assets is *ST Zixue. In 2017, goodwill accounted for 2330.59% of net assets. With the increase in mergers and acquisitions and reorganizations, the accumulated goodwill in the overall assets of listed companies is getting larger and larger. Can these goodwill really bring excess profits to the company? It is worth noting that if the M&A premium in mergers and acquisitions is too high, then the risk that companies need to impair their goodwill in the future has greatly increased. Once the accumulated high amount of goodwill is impaired, the asset impairment loss that needs to be recognized will cause a serious decline or even loss in the profits of the acquired company that year. Since BlueFocus and Watson Biologics accrued huge impairment losses on goodwill in 2015, many listed companies have issued annual reports on performance losses due to accrued large impairment losses in 2017. For example, Zhongke Jincai lost RMB 237 million in 2017, which was mainly due to the provision of goodwill impairment for the decline in the performance of its subsidiary Tianjin Binhe Innovation Technology Co., Ltd. Qianshan Pharmaceutical Machinery lost 324 million yuan in 2017, mainly due to the total provision for impairment of Hunan Le Fudi

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Pharmaceutical Packaging Materials Technology Co., Ltd.'s goodwill of 314 million yuan. Lianjian Optoelectronics, Absen, and Fuchun Co., Ltd. also accounted for large amounts of goodwill impairment due to the company's failure to meet expectations, resulting in a significant loss or decline in the company's profit in 2017. The impairment of goodwill has become a performance mine for listed companies, which may detonate at any time, triggering a major dive in performance. According to Wind statistics, from 2013 to 2016, the amount of goodwill impairment accrued by A-share listed companies increased year by year, but basically did not exceed 1% of the total accumulated goodwill that year. With the expiration of the high-premium M&A performance commitment, many listed companies face the risk of huge impairment of goodwill, forming a huge "bubble" of goodwill.

1.2 Literature overview

Some scholars believe that there is a huge amount of goodwill in the current mergers and acquisitions practice, but in the actual impairment of goodwill, companies often carry out extreme treatments, either without impairment or all impairment, which is actually unfavorable for the company and believes Explore a more reasonable method of confirming the impairment of goodwill; Xu Jialin's (2006) research also emphasizes the importance of studying the follow-up measurement method of goodwill. Zhao Hui et al. (2008) pointed out that goodwill impairment testing methods are cumbersome and the testing process is not transparent, and proposed that report preparers should disclose relevant information to meet the needs of report users; Zhou Hua et al. (2010) believe that current merger goodwill is adopted The accounting treatment of fair value involves significant predictability and many hypothetical factors, and has theoretical and practical flaws; Feng Weidong (2010) studied the follow-up measurement method of goodwill and proposed the use of excess profitability and related factors to impair goodwill The point of view of the test.

2. Problems in the initial recognition of goodwill and its impairment measurement

2.1 Initial confirmation-confirmation method

In 2006, my country's CAS 20 stipulated that the difference between the purchaser's merger cost and the fair value of the identifiable net assets of the purchaser obtained in the merger should be recognized as goodwill.

2.1.1 Reverse balance

The value of goodwill is determined by "reverse rolling" of the difference, which obscures the value of real goodwill, leading to inaccuracy in the initial recognition of goodwill. Moreover, the purchase price is easily affected by the valuation and

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bargaining power of both parties to the merger, which will cause the confirmed goodwill to contain other non-goodwill components and deviate from the essence of goodwill.

2.1.2 M&A and restructuring pricing

As the main basis for the pricing of mergers and acquisitions of listed companies, the commonly used methods of asset evaluation include asset-based method, income method, and market method. Different appraisal methods have different applicability, and the valuation difference of the evaluation target is also large. The target premium rate assessed by the income method is the highest. The average premium rate since 2014 has reached 937%, which is much higher than the market method's 373% and the asset-based method's 410%. The income method evaluates the present value of the expected future returns of assets, and is applicable to assets with operating records and predictable future returns. Since valuations under the income method imply many assumptions and have more flexible operating space, in recent years, the proportion of listed companies using income method in mergers and acquisitions has increased.

2.2 Initial confirmation-confirmation scope

2.2.1 Intangible assets and goodwill

The enterprise acquires a series of assets of the acquiree through the merger, including not only the tangible assets and the intangible assets confirmed in the financial statements of the acquiree, but also some intangible assets owned by the acquiree but not confirmed in the financial statements. Such as the non-patent technology formed by internal research and development, the brand generated, the unique ability formed by the management, etc. These intangible assets that are not reflected in the financial statements of the acquiree are likely to meet the criteria for identifiable intangible assets at the level of the purchaser’s merger and should be recognized. However, in the current practice, due to the inaccurate grasp of accounting standards by companies, the intangible assets are not fully recognized during the merger process, such as popular online and mobile game industries that have been successfully developed and launched games, electronic technology and communications industries. Non-patent technologies developed by internal research and development, animation copyrights in the animation industry, well-known game platforms in the online game industry, high-quality media advertising resources in the advertising industry, high-click websites in the online education industry, and industry with high market barriers Contractual customer relationships established by large downstream manufacturers are in line with identifiable intangible resources and are directly recognized as goodwill without confirming intangible assets at the merger level.

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2.2.2 Excess profitability and the cost of purchasing high performance

Performance commitment is a gambling agreement generated by both parties in an M&A and restructuring transaction in order to reach an agreement on the pricing of the underlying asset. The original intention of the system is to prevent the undervalued assets from being undervalued and fair and reasonable to protect the interests of listed companies and small and medium investors in restructuring transactions. However, in reality, some target sellers make performance commitments only for the purpose of putting in asset evaluation and appreciation, and exchange unrealistic high performance commitments for higher transaction prices; listed companies in order to successfully complete the acquisition (not ruled out based on the motivation of benefit transmission), Stimulate the secondary market share price, under the premise of not fully measuring the growth and profitability of the underlying asset, it is also willing to accept high performance promises. Therefore, the high performance promise of M&A and restructuring is the result of the current mutual game between the two parties, but it takes time to test whether the acquired party can fulfill it on schedule.

In business mergers, there are many acquired companies that do not have excess profitability, but in order to obtain high valuations, they often give higher performance commitments. In the evaluation for the purpose of mergers and acquisitions, the evaluation method generally adopted by enterprises is the income method, which is an evaluation method to determine the value of the evaluated asset by estimating the expected future income of the evaluated asset and converting it into the present value. Therefore, the purchase price determined under the income method will far exceed the fair value of the identifiable net assets of the acquiree. In the current practice, most companies have not considered the essence of this part of the premium from the essence of the transaction. At the level of business mergers, they have not distinguished which are the excess profitability of the acquired unit, which can confirm goodwill; which is only It is the cost incurred to purchase high performance and should be amortized as an offset against income, but simply believes that as long as the purchase price exceeds the fair value of the identifiable net assets, it is goodwill. The harm of this method is that the price paid in advance to obtain future profits will still be booked when it is actually obtained in the future, which inflates the profits in the future period.

2.3 Impairment measurement-how to measure

2.3.1 Unit of measurement

"Accounting Standards for Business Enterprises No. 8-Asset Impairment" introduces the concept of asset group, and stipulates that the impairment test and confirmation of goodwill should be carried out in conjunction with its related asset group or combination of asset groups. The so-called asset group and asset group combination are two important concepts of asset impairment standards. The former is essentially the smallest combination of a series of assets that can independently

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generate cash inflows in an enterprise, and the latter is the smallest combination of several asset groups. Portfolio of asset groups. The so-called asset group or combination of asset groups related to the goodwill impairment test should be the asset group or combination of asset groups that can benefit from the synergies of business combinations. This definition has its shortcomings. Although the standard stipulates that when identifying an asset group, the management method of the company’s management of production and operation activities and the decision-making method of the continued use or disposal of assets should be considered, but it does not reduce goodwill. To what level the value can be “pushed down” to limit, this brings difficulties in actual operation: what range of corporate asset portfolio meets the conditions of the “minimum” identifiable asset portfolio, and how to determine the asset group or cash output Unit, this is very abstract.

2.3.2 Measurement basis

The "Accounting Standards for Business Enterprises No. 8-Asset Impairment" also requires comparing the book value of each related asset group or combination of asset groups with its recoverable amount to determine whether it is impaired. The recoverable amount should be based on the fair value of the asset minus the disposal cost the higher of the subsequent net amount and the present value of the expected future cash flow of the asset shall be determined. However, there are still some problems in the specific implementation. One is the uncertainty of the scope of cash flow. In the process of the impairment test of consolidated goodwill, the standard does not make clear and mandatory provisions on the scope of cash flow, which will cause the company to choose a non-uniform measurement basis. Some companies will the expenses are deducted from the cash flow, while some companies do not. In this way, the information loses horizontal comparability; the second is the method of determining the present value of cash flow. Two methods are still given when determining the present value of cash flow, risk-adjusted cash flow method and one-time adjusted discount rate method. There is no difference between these two methods when determining the cash flow at a point in time, but when testing a continuous period of time, the difference is obvious. Therefore, the determination of the recoverable amount is uncertain.

2.4 Impairment measurement-where to include

The standard stipulates that the impairment test method shall be adopted for the subsequent measurement of goodwill. It requires companies to conduct an impairment test on the asset group or combination of asset groups related to goodwill at the end of each fiscal year. If impairment occurs, the impairment loss of goodwill shall be recognized. The balance sheet discloses the net value of goodwill after deducting the "goodwill impairment provision", and discloses the goodwill impairment loss in the "asset impairment loss" item of operating profit in the income statement. This method of using goodwill impairment losses to offset profits is, on the one hand, illogical. Because there is a substantial difference between the profit loss and the income expense, the profit loss comes from the non-production and operation process, and the cost expense comes from the production and operation process. The impairment of goodwill is an unrealized loss, not the cost and expense incurred in the business process. It belongs to the category of income statement reflection. On the other hand, it provides companies with huge room for earnings management. Recognizing impairment of goodwill as a profit deduction is likely to cause companies to use a large amount of goodwill impairment to manage earnings and manipulate profits.

3. Suggestions

3.1 Initial confirmation

On the one hand, at the time of merger, the purchaser should confirm the assets created by the purchasee and meet the standards of intangible assets, and amortize them in the future income years to purify the recognition of goodwill; on the other hand, for intangible assets The asset standards make necessary amendments to expand the scope of intangible assets that can be recognized and further converge with IFRS.

For another situation, the form of "goodwill" is formed due to the higher performance commitment given by the acquiree during the merger (the acquisition price determined according to the income method evaluation data is far greater than the identifiable purchaser Fair value of net assets). In this case, the inflow of benefits to the enterprise in the future is actually an incidental cost, that is, the above-mentioned form of goodwill will not amortize the cost while confirming the income, which does not conform to the cost-benefit ratio principle. Therefore, at the merger level, the above-mentioned unconventional assets should be separated from the merger premium, recognized in the form of long-term deferred expenses, and amortized within a certain period of time to purify the value of goodwill. At present, there are many unfulfilled performance commitments of acquired companies in the securities market, which in essence also indicates that goodwill is likely to have signs of impairment to a certain extent, and corresponding impairment provisions should be considered.

3.2 Impairment measurement

It is recommended to change the follow-up measurement of goodwill to a combination of "system amortization + impairment test", and stipulate the maximum period that amortization cannot exceed. This method has the following advantages: First, in view of the current situation where the goodwill of listed companies is generally abnormally high, amortization is more like a "uniform" release of risk than impairment, instead of a large amount of goodwill at one time. The "accelerated" risk release due to impairment is conducive to stabilizing the expectations of market entities. Second, amortization is a continuous long-term process, which will affect

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the company's profit and loss for several years in the future. This will force listed companies to be more cautious at the beginning of M&A activities to judge whether the valuation of M&A assets is falsely high, thereby guiding the goodwill generated by M&A and restructuring to gradually return to a reasonable range.

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