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A Study on Goodwill Impairment Risk and Prevention for Continuous Mergers and Acquisitions of Company T

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Abstract: *At present, the huge goodwill bubble of listed companies and the one-time provision of large goodwill impairment have become an important issue affecting the healthy development of the capital market. This paper takes Company T, a typical case of goodwill impairment in continuous mergers and acquisitions, as the research object, and systematically collates the process of continuous mergers and acquisitions of Company T and the formation and impairment process of huge amount of goodwill, and finds that its high valuation and high premium continuous mergers and acquisitions have brought about huge goodwill impairment risks. In order to effectively prevent these risks, according to the specific risk causes, this paper puts forward some risk prevention suggestions, such as carefully treating performance commitment, improving corporate governance structure, optimizing enterprise value evaluation system, and adopting the follow-up measurement method combining amortization and impairment.*

Keywords: *Listed company T; Continuous M&A; Goodwill impairment risk*

1. Introduction

In recent years, in order to carry out rapid expansion, many listed companies choose to carry out multiple mergers and acquisitions in a short period of time. However, such continuous mergers and acquisitions are likely to bring huge goodwill impairment risks. Once huge goodwill impairment occurs, it will not only hit the operating conditions and future development ability of enterprises hard. Moreover, the existence of information asymmetry will also make the interests of small and medium investors more vulnerable to damage, which is not conducive to the benign development of the capital market. It is very unfavourable to the benign development of the capital market. This paper applies case study method, literature research method and comparative analysis method, selects the typical case of goodwill impairment in continuous mergers and acquisitions (M&A) of Company T for research, identifies the risk of goodwill impairment in continuous M&A, analyses the causes of the risk, and finally gives corresponding suggestions on how to prevent these risks from various angles.

2. Introduction to the case of goodwill impairment of Company T's successive acquisitions

2.1. T Company Profile

Company T was established in Beijing in March 2010. After several years of development, Company T was successfully listed in Shenzhen Stock Exchange in July 2014. It belongs to the Internet and related service industry, mainly engaged in the development and operation of online games.

In order to realise business expansion and industrial upgrading, Company T made ten consecutive mergers and acquisitions with the help of the capital market within three years after its listing, involving game design, internet advertising, film and television entertainment and other fields, and gradually accumulated huge amounts of goodwill. In the pre-M&A period, Company T sent signals to the capital market that the company had sufficient funds and good development through a number of high-value, high-premium M&A, prompting the share price to rise continuously, and the highest market value had reached 40 billion yuan. However, at the late stage of mergers and acquisitions, the risk of goodwill impairment brought about by consecutive high-premium mergers and acquisitions gradually came to the fore. In 2018, due to the impact of industry policy adjustments and other factors, T

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Company made a one-time provision of more than $4 billion of huge goodwill impairment, and its net profit turned from positive to negative, with a loss of about $7 billion, leading to a total collapse of the stock price and triggering a delisting crisis.

2.2. Successive merger and acquisition processes

Since its listing in 2014, T Company has adopted an epitaxial development strategy, directly merging and acquiring ten companies through mergers and acquisitions, investment and equity participation, etc., gradually transforming from the original single business model to a diversified development model, and striving to create an enterprise-wide industrial chain pan-entertainment aggregation platform. Its consecutive M&A transactions between 2015 and 2017 are detailed below:

In 2015, Company T entered a phase of rapid expansion, directly acquiring five companies within a year. In February of that year, a wholly-owned subsidiary of Company T purchased 100 per cent of Company A, whose main business is the distribution and operation of mobile application platforms, for a cash payment of 600 million yuan. In October of the same year, Company T purchased 95 per cent of Company B and 100 per cent of each of Companies C, D and E by issuing shares and making cash payments, respectively, for a total transaction price of RMB 3.58 billion. Among them, Company B and Company C are mainly engaged in the R&D and operation business of games, while Company D and Company E are engaged in the operation and maintenance of websites and technical support of Internet advertising platforms respectively.

In 2016, Company T further expanded its game industry layout. In October, a wholly-owned subsidiary of Company T used its own funds of RMB986 million to acquire a 100% equity interest in Company F. Company F is mainly engaged in the research and development and operation of casual chess and card games. Upon completion of the transaction, the profitability, independent research and development capability as well as the competitiveness of Company T in the same industry were further enhanced. The Company F is a subsidiary of Company T, which is engaged in the research and development and operation of casual chess and card games.

In 2017, Company T continued to make four mergers and acquisitions, and was committed to creating an integrated industrial chain layout of games, film and television, and advertising. In January, Company T once again purchased 93.54% of Company G and 96.36% of Company H, whose main businesses are global distribution of online games and integrated marketing of branded content, respectively, through the issuance of shares and payment of cash. In February, Company T acquired 42% of Company I, which is mainly engaged in local In May, Company T went on to acquire a 50.71% stake in Company J, whose main business is software and information technology services.

2.3. Formation and impairment of significant goodwill

2.3.1. Goodwill formation

In the course of the above continuous high premium mergers and acquisitions, Company T gradually accumulated huge amounts of goodwill.

In 2015, Company T directly merged and acquired five companies, with a total transaction consideration of $4.149 billion, with the highest premium rate as high as 966.67 per cent and the lowest premium rate reaching 200 per cent, resulting in a total of $3.665 billion of goodwill, which accounted for 50.16 per cent of the total assets of $7.306 billion at the end of the 2015 period.

In the acquisition of Company F completed by Company T in 2016, the transaction consideration was $986 million, a premium of approximately 10.74 times, and the amount of goodwill recognised was $902 million, or 91.48 per cent of the cost of the merger. The closing balance of goodwill as a percentage of the closing balance of total assets increased further in 2016, exceeding 60 per cent.

In 2017, Company T once again acquired four companies for a total transaction consideration of $4,637 million, with the highest premium of 1,321.21% and the lowest premium of 200% during the period, resulting in a total of $3,890 million in new goodwill. As a result of the continuous foreign investment of T Company during the period, the overall size of the company increased substantially, and the closing balance of goodwill of the company totalled 6.541 billion yuan in 2017, accounting for about 45.42% of the total assets. Although the proportion of goodwill to the company's total assets decreased in the current period compared to the previous period, in general its amount was still high, and the huge amount of goodwill was thus formed.

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2.3.2. Impairment of goodwill

According to the data of the annual reports of Company T published in the past years, it did not make any provision for goodwill impairment in 2014 and 2015 in the pre-acquisition period, and only made a provision for goodwill impairment of 0.14 billion yuan and 0.30 billion yuan in 2016 and 2017, respectively. And in 2018, the game industry and film and television industry, which are closely related to T Company's main business, became more strictly regulated, and the performance commitments signed by consecutive mergers and acquisitions in previous years expired in a concentrated way. Many subsidiaries of Company T were impacted to a certain extent, and goodwill impairment provisions were made substantially, totaling 4.06 billion yuan. The book balance of goodwill at the end of the period was reduced by 60% compared with the previous period. Huge goodwill impairment events broke out.

In 2018, more than 83% of the subsidiaries of Company T recorded goodwill impairment losses of more than 50% of their original value: Company B recorded $427 million, with an impairment ratio of 84.72%; Company C recorded $783 million, with an impairment ratio of 100%; Company F recorded $900 million, whose impairment ratio also reached almost 100%; the impairment ratios of Companies G, H, and J, respectively, also reached 58.13%, 37.50% and 53.00%.The huge one-off goodwill impairment provided by Company T in 2018 had a serious adverse impact on the performance of the current period, which turned the net profit of the current period from positive to negative.

3. Analysis of the risk of goodwill impairment and reasons for the successive acquisitions of Company T

3.1. Identification of goodwill impairment risk of Company T's successive acquisitions

3.1.1. Risk of large performance losses

Subsidiaries acquired by Company T through high premiums were unable to realise the expected returns, leading to the gradual exposure of its operational risks and a serious impact on its future profitability. In 2018, T Company made a total of 4.06 billion yuan of goodwill impairment provisions, which directly led to the company's net profit loss reached about 7 billion yuan, down 664.11% compared to the net profit of 2017, of which the amount of goodwill impairment provisions accounted for as much as 58.18% of the loss amount. In short, the continuous accumulation of goodwill is easy to increase the risk of goodwill impairment of the company. The higher the goodwill is, the more likely the asset impairment loss caused by it is to adversely affect the company's profits, and the uncertainty of the company's future performance will also increase significantly.

3.1.2. Debt service risk

Compared to 2014 before the commencement of the merger and acquisition, after the commencement of the successive mergers and acquisitions, both the short-term and long-term solvency of Company T has been declining, and the financial indicators measuring solvency are significantly different relative to the industry averages. Among them, the cash ratio, which measures short-term solvency, decreased significantly from 4.22 in 2014 to 0.18 in 2018 (industry average 1.20) and 0.10 in 2019 (industry average 1.41); the current ratio also declined sharply from 6.16 in 2014 to 0.63 in 2018 (industry average 2.57) and 0.40 in 2019 (industry average 2.36). Meanwhile, the long-term solvency of Company T also declined significantly, with its gearing ratio rising from 10.90% in 2014 to 72.65% (industry average 29.62%) in 2018 and 86.70% (industry average 39.54%) in 2019.

Company T issued a series of statements in early 2019 regarding its inability to repay its debts on time as they fell due, indicating that the company was in a very difficult financial position and was unable to repay a number of loans. This was largely due to the fact that Company T had raised a significant amount of capital for its successive merger and acquisition transactions in the form of cash payments and the like in the early stages of the process, but had failed to focus on synergies in the later stages of the process, which, together with a number of other factors, combined to result in a significant deterioration in its financial position.

3.1.3. Risk of share price collapse

At the initial stage of successive mergers and acquisitions, Company T signalled to the market that it was well-funded and well-operated, which was vigorously pursued by investors. At the same time, Company T's layout of the pan-entertainment industry chain through its planning led small and medium-sized investors in the market to overestimate the company's potential for future development,

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and then blindly follow up and buy the company's shares.

But the more overvalued the stock price is, the greater the future risk of goodwill impairment the listed company will face.[1] As the process of successive mergers and acquisitions advances, the stock price of Company T and the valuation of the company are rising, thus forming a high stock price bubble. According to the signalling theory, the market is bound to react fiercely to Company T's huge goodwill impairment crisis after it breaks out. At this time, the huge goodwill impairment makes the company's performance decline sharply, investors will naturally question the company's future profitability and development prospects, and it is very likely to think that the company's current share price is too high, so they will choose to sell their shares as soon as possible to reduce their own losses.[2] In a situation where the market is not optimistic about the company, the behaviour of investors selling a large number of shares will certainly lead to sharp fluctuations in the share price, which in turn leads to the risk of a share price crash.[3]

3.1.4. Small and medium-sized investor risk

Between 2015 and 2018, a number of major shareholders of Company T made multiple reductions in their holdings in order to cash out, which is in sharp contrast to the frenzied pursuit and buying behaviour of small and medium-sized investors in the capital market. The behaviour of major shareholders in reducing their holdings indicates that they have, to a certain extent, realised the risk of goodwill impairment formed by the company's successive high-premium mergers and acquisitions, and are aware that the company's market value will be hit hard if the merged company's operation runs into problems and fails to achieve its pre-determined targets. Therefore, rational major shareholders will intentionally avoid disclosing information about the company's goodwill impairment risk when the market value is overvalued, and at the same time utilise their own information advantage to cash out when the company's share price is still at a high level, transferring the company's wealth.[4]

However, in contrast, for small and medium-sized investors, it is difficult for them to get timely and unfavourable information about the development of the company.[5] On the day following the publication of the annual report in 2018, the share price of Company T fell to $5.71 per share, which is a drop of more than 85% from the peak of the share price. At this time, most of the small and medium-sized investors who bought the shares when the share price was higher had difficulties in selling out their shares in time and suffered huge financial losses.

3.2. Causes of Goodwill Impairment Risk in Company T's Successive Acquisitions Analysis

3.2.1. High performance commitments are difficult to fulfil on a sustainable basis

From the information disclosed by Company T, most of its successive mergers and acquisitions have signed performance commitments, and the performance commitment period with the acquired companies is usually three years, and in the current period of the merger and acquisition, the merged party promises the largest increase in performance, while the promised increase in performance in the following years tends to increase steadily. However, in the course of successive mergers and acquisitions, the operating conditions of a number of acquired companies deteriorated over time and did not reach the expected level, and coupled with the weak synergies brought about by the previous mergers and acquisitions, many of the high performance commitments were difficult to fulfil on a sustained basis. According to the various audit reports published by Company T, a number of acquired companies failed to fulfil their performance commitments for one to two years during the performance commitment period. It can be seen that if the signed performance commitment is higher than the actual ability, the performance commitment will certainly be difficult to fulfil, which not only can not guarantee the asset value of the subject company, but also easy to make the risk of high valuation even more serious, which in turn triggers a higher goodwill impairment risk.[6]

3.2.2. Extreme internal controllers make the internal checks and balances of the enterprise dysfunctional

According to the "Foreign Investment Management System" published by Company T, the organisations deciding on the specifics of Company T's foreign investment are the Company's General Meeting of Shareholders, the Board of Directors and the General Manager's Office. The Strategy Committee of the Board of Directors is the leading body for outward investment and is responsible for formulating the Company's long-term development strategy and studying the feasibility of the Company's major investment decisions, while the General Manager is mainly responsible for the implementation of the outward investment strategy. Among them, the members of the Strategy

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Committee are nominated by the Chairman of the Board, more than half of the independent directors or more than one-third of all the directors, and are elected by the Board. The members of the Strategy Committee consist of three directors, including at least one independent director.

Zhu held the position of head of the strategy committee of Company T from 2014 until October 2018. And in fact, Zhu was not only the controlling shareholder of the company, but also the chairman and general manager of the company, combining governance and management powers. This led to the fact that T's foreign investment decisions depended entirely on Zhu alone, who was responsible for both the initial assessment and recommendation of the company's major investment projects, as well as the approval of the final decision to implement them, resulting in a checks and balances mechanism that floated on the surface, and was an extreme internal controller.[7] This ultimately leads to the failure of the monitoring mechanism during the M&A process and increases the risk of over-investment by the internal controller in order to maximise his personal interests.

3.2.3. Income approach is not appropriate for the valuation of the acquired company

The income approach mainly determines the value of a company based on its future profitability, but this also makes this valuation method have unavoidable limitations.[8] The method is mainly applicable to enterprises with stable earning capacity and large capital investment, while for asset-light industries including the Internet industry, the company's operating performance is very sensitive to changes in the external environment, and the product renewal speed is relatively fast, which makes the company's future operating conditions highly uncertain. At the same time, the selection of the relevant discount rate is also susceptible to interference by a variety of subjective factors, making the risk difficult to quantify. The uncertainty in the level of future earnings, coupled with the irrationality of the valuation method used, makes Company T, as an asset-light company, not suitable for the income approach.[9] And 8 out of the 10 companies that Company T has consecutively acquired use the income approach for valuation, which leads to certain irrationalities in the company's enterprise value assessment and lays a hidden danger for goodwill impairment risk.

3.2.4. Inadequate subsequent measurement of goodwill

China's current accounting standards require listed companies to review goodwill for impairment at the end of each accounting period, but in practice, the impairment testing method used for this exercise gives companies a great deal of discretion.[10] Under this accounting treatment, the management of a company is likely to hide specific information about its goodwill impairment risk from the outside world in the early stage for the purpose of attracting investments from outside investors, etc., and make a one-off provision for goodwill impairment at a later stage. However, this kind of behaviour can easily lead to huge losses for small and medium-sized investors and expose the company to a higher risk of goodwill impairment.

The higher the amount of goodwill initially recognised, the more likely it is that the company will engage in surplus management practices, and the more room for manipulative surplus management.[11] T Company's many acquisitions in the course of its successive mergers and acquisitions have been high premium mergers and acquisitions, which has led to the formation of a huge amount of goodwill in the company. At this time, once the goodwill impairment loss is recognised, it will have a great negative impact on the company's operating condition. Therefore, the management of Company T had the pressure, motivation and opportunity to avoid the goodwill impairment provision in the previous years. It can be seen that the problem of imperfect subsequent measurement of goodwill creates conditions for the formation of goodwill impairment risk.

4. Suggestions for preventing the risk of goodwill impairment of successive mergers and acquisitions of Company T

It can be seen from the above analysis that T Company's continuous high valuation and high premium M&A behaviours have brought about a huge goodwill impairment risk, which in turn has brought about many adverse impacts to many parties. Therefore, in order to better prevent these risks, listed companies should start from themselves and strengthen the control of risks before, during and after M&A, and the relevant departments should also continue to improve the value assessment system and the subsequent measurement of goodwill.

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4.1. Prudence in viewing performance commitments

First of all, it is necessary to make sufficient preparations in the pre-merger and acquisition period, and conduct a comprehensive investigation of the subject company's basic business operations, asset status, development prospects and whether it has the potential for development. In order to more accurately assess the value of the enterprise, you can also consider hiring industry analysts, financial advisers and other experts in related fields, and according to the actual situation to determine the specific and appropriate merger and acquisition programme. In short, M&A parties should abandon short-sighted thinking and try to fully understand the development status of the target company through various methods and identify the risks that may arise before and after the M&A, so as to prevent unnecessary M&A premiums and avoid the formation of excessive goodwill.

Secondly, it should also do a good job in the integration management in the late stage of M&A, give full play to the synergy effect, and improve the efficiency of the performance of the target company. M&A integration management includes corporate culture integration, human resources integration, business process integration, financial integration and other aspects, a good internal and external environment for the target company to complete the performance commitment is very favourable, so the listed company should pay attention to and strengthen the integration management of the late stage of the merger and acquisition, to enhance market competitiveness at the same time, but also to enhance the overall anti-risk ability, as far as possible to reduce the goodwill impairment risk of the company. The possibility of goodwill impairment is reduced as much as possible.

4.2. Improvement of corporate governance structure

Firstly, listed companies should focus on the improvement of the internal governance structure, separate the powers of the general manager and the chairman of the board of directors, strengthen the checks and balances of the company's internal rights, and ensure the independence of the board of directors.

Secondly, both regulators and listed companies should pay attention to the independence of independent directors at the institutional level. For example, when selecting and hiring independent directors, the selection process must be standardised to ensure the independence and professionalism of independent directors as well as the effectiveness of supervision.

Finally, the relevant regulatory authorities need to strengthen the review and approval system for successive mergers and acquisitions of listed companies, establish and implement a life-long accountability system for the actual controllers and management of the companies, improve the disciplinary measures for offences and increase the level of punishment, so as to curb at the root of the problem the implementation of short-term over-investment by listed companies. At the same time, it is also necessary to construct a set of effective regulatory mechanisms to strictly examine and approve M&A proposals with high valuations and high premiums, and to pay close attention to all kinds of unlawful and illegal behaviours of listed companies in the course of their management and operation, so as to ensure the smooth development of the capital market.

4.3. Optimising the enterprise valuation system

In order to make the value appraisal of light-asset enterprises more scientific and reasonable, the appraisal should be conducted with full consideration of the industry characteristics and business types, reasonable judgement of their expected returns, and comprehensive consideration of the various business risks, so as to make the appraisal results more scientific and reasonable. In addition, common valuation methods mainly include the market method, cost method and income method, each of which has certain advantages and disadvantages. In conducting the valuation, consideration may be given to adopting several different valuation methods at the same time, such as selecting a certain combination of valuation methods at different stages of the company's development, so as to ensure the reasonableness of the valuation range.

4.4. Subsequent measurement using a combination of amortisation and impairment

In order to solve the problem of imperfect subsequent measurement of goodwill, the combination of amortisation and impairment testing can be considered. That is, in a fixed period, at the end of each period on the amortisation of goodwill, and when goodwill signs of impairment, but also on the

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goodwill impairment test, will be related to the book value of the asset or asset portfolio and its recoverable amount for comparison, if the book value is higher than the recoverable amount, then the enterprise should be recognised as goodwill impairment loss. This will not only not affect the company's profit to a greater extent, but also does not leave too much discretion to the company's management, which is conducive to the strict review of high-premium continuous mergers and acquisitions to reduce the risk of goodwill impairment due to continuous mergers and acquisitions.

5. Conclusions

In conclusion, once the huge goodwill impairment occurs, it will not only hit the enterprise's operation status and future development ability, but also the existence of information asymmetry will make the interests of small and medium-sized investors more vulnerable to damage, which is very unfavourable to the benign development of capital market. Therefore, enterprises, relevant institutions and investors should work together to prevent the risk of goodwill impairment from various aspects, and jointly maintain the stability of the capital market.

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