COMPANY'S INTERNALLY GENERATED GOODWILL – KEY FACTOR FOR ITS DEVELOPMENT. APPROACHES FOR EVALUATION AND DISCLOSURE IN THE FINANCIAL STATEMENTS

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Abstract: *It is getting more and more burdensome to maintain company's competitiveness in the modern globalized world basing on traditional assets which are available to competitors as well. Companies turn to the generation of, and development of, unique assets having no analogues, intended to guarantee their sustainable development. Very often, the stock exchange valuations of companies are much higher than their accounting values. This discrepancy serves as evidence that the assets not reflected in the Balance sheet play a principal role in the generation of corporate wealth. The purpose of this paper is to present a research under the project titled "Approaches and Methods of Reporting and Disclosure of Internally Generated Goodwill of an Enterprise". For the purposes of this research, the author adopted a system of three operational approaches. The first approach concerns the determining of InGIA as synergetic factors of InGG. This approach focuses on the method of determining InGIA which are at the bottom of synergy generation. The second approach based on residual value allows evaluating InGG, from the perspective of the fundamental position that the nature of InGG and ExGG is the same. The third approach is based on market capitalization. A further development of Bloom's method has been made which provides for the more precise determining and disclosing of InGG for the entities listed and not listed on the stock exchange.*

Keywords: *goodwill, internally generated goodwill, accounting, intangible assets, disclosure in annual financial statements*

INTRODUCTION

The statutory framework for the regulation of goodwill is IFRS 3 Business Combinations, which is relevant for entities applying IAS as a reporting base. According to IFRS 3 Business Combinations, goodwill is defined as an asset representing future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

There are two types of goodwill – positive goodwill and gains of a profitable bargain (negative goodwill). Goodwill has two characteristics: in the first place, it is regulated by a normative document which in this case is IFRS 3, and secondly, it is connected with the acquisition of assets which appear to be external for the entity. These characteristics give a reason to provisionally call this goodwill "externally generated goodwill" with the implication that it is statutory regulated.

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Externally generated goodwill (regardless of being positive or negative) represents a resulting effect of the business combination, which in its essence is synergetic, i.e. supplementary effect „in excess", or excess profit. When speaking of positive goodwill, this effect is expressed in monetary terms by the extra paid price for the acquisition of the combination compared to the net amount of the identifiable assets acquired and the liabilities assumed. With negative goodwill, this effect is expressed in monetary terms by the net amount of identifiable assets acquired and liabilities assumed obtained in excess when compared to the price paid for the acquisition of the business combination.

It is evident from the foregoing that, in business combinations, goodwill is identifiable in economic terms, in documentary and monetary terms, which allows to be easily standardized.
In practice, however, there is also internally generated goodwill (InGG), for which there is no regulatory standard available. The purpose of this paper is to present a research under the project titled "Approaches and Methods of Reporting and Disclosure of Internally Generated Goodwill of an Enterprise".

It is getting more and more burdensome to maintain company's competitiveness in the modern globalized world basing on traditional assets which are available to competitors as well. Companies turn to the generation of, and development of, unique assets having no analogues, intended to guarantee their sustainable development. Very often, the stock exchange valuations of companies are much higher than their accounting values. This discrepancy serves as evidence that the assets not reflected in the Balance sheet play a principal role in the generation of corporate wealth.

Generally, there are two main approaches used for the measurement of InGG. The first of them involves the calculation of the present value of expected extra profit, which is defined as the residual income approach according to the formula offered by Ohlson (1991, 1995). The other one is based on the difference between the fair value of company's assets and the net worth of the company in the event of business combination.

For the purposes of this research, the author adopted a *system* of several operational approaches which:

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- have to allow the evaluation of InGG of maximum number of companies (quoted or not quoted in the stock exchange) with minimum costs;
- have to measure the synergetic effect of the interaction of all company's assets;
- get specific and further developed in order to expand their scope of application and to increase their measurement accuracy.

The approaches used are: (A) approach, for determining InGIA (internally generated intangible assets) as synergetic factors of InGG, (B) approach, based on residual value; (C) approach based on market capitalization.

The first approach, approach A, stems directly from the nature of InGG, but in this approach the spotlight falls on the method of determining InGIA, which are at the bottom of synergy generation. The principal method of determining the value of InGIA[20] is the calculation of prime cost.

The second approach, approach B, originates directly from the nature of InGG, i.e. synergetic effect, the value of which is determined as the difference between company's acquisition price and the fair value of the net assets.
The third approach, approach C, is a modification of the first approach, because it has the same logics for determining the value of InGG, but it involves the market methods for determining company's worth and specifically the market capitalization. That is why, it has the right of individual existence. This method is applicable for entities listed on stock exchange.

Approach A, for determining InGIA as synergetic factors of InGG is necessary for the purpose of evaluating InGIA in order to subtract their value from company's net worth (together with the value of the net assets), to get the synergetic value of the interaction of assets, which is assumed as a goodwill value. The objective determining of the value of InGG is dependent on the objective identification and determining of the value of InGIA. On the other hand, intangible assets are at the root of the generation of InGG, therefore, it is required to make a specific examination.

In author's point of view, the recognition criteria, in the current regulatory framework concerning the recognition of intangible assets, are too restrictive and impede the recognition of many intangible assets, especially of InGIA. No one in the business practice would make expenses which wouldn't bring economic benefits. That is an imminently inherent feature of business – business risks and exists because risky activities bring earnings higher than the capital investing opportunities of no or low risk. Therefore, it is used for the purposes of determining InGIA, their subordination according to their significance and the criterion of greatest significance has to be (1) ability to generate future benefits, then (2) measurability of asset's value, (3) controllability and (4) identifiability. We specify the first two criteria as "strict" criteria for the identification of InGIA. The last two criteria are determined as "non-strict".

In connection with *approach A* set out above, we can make the following summary:
a) InGIA have to be evaluated and disclosed as a Note to the Annual Financial Statements, which is supposed to improve the objective reflection of the economic environment in the annual financial statements;

[20] InGIA – internally generated intangible assets

b) a conceptual framework of the approach is offered, which facilitates the further specification of the instrumentarium of the approach;
c) the cost method is the main method within the approach, and some "calculation elements" are offered in the conceptual framework, which reflect the status of InGIA. The status generally involves the circumstance, whether the InGIA is protected against encroachments of third parties, and more particularly, whether the access of such parties to the usage of the economic benefits is restricted.

Approach B, based on residual value, is based on the fact that ExGG and InGG are similar by nature. It is proven that unequal treatment of internally and externally generated goodwill, when being evaluated, does not reflect the objective economic environment and is a generator of negative effects in the economy and undermines economic growth. In order to avoid such negative effects, it is necessary that InGG is considered equal in status to ExGG, and the information about entity's InGG should be presented to the management and investors, regardless of the regulatory provisions.

The conceptual framework of the approach is depicted by three main principles:
a) Entities which have not performed business combinations, i.e. InGG needs to be calculated for them, can be distinguished into three groups:
(aa) entities listed on the stock exchange;
(ab) entities which are not listed on the stock exchange, but are well placed on the market, and are profitable and stable in their development;
(ac) entities, which are not listed on the stock exchange and do not meet the stability requirements.
b) Evaluation of InGIA the value of which is deducted from the residual value. They are measured at fair value, the same as with InGG.

The need of the evaluation of InGIA arises from the fact that InGG increases when InGIA are not recognized and reported. The non-recognition of InGIA "artificially/falsely" increases the value of InGG. Therefore, similar to the approach with ExGG, the right to evaluate InGIA should be applied for InGG as well, so that the residual value could be reduced by them. Thus, the monetary expression of InGG will become objective and fair.

It is assumed for business combinations that fair value is the most appropriate characteristic feature of the assets acquired and liabilities assumed. Fair value measurement provides information which is more comparable and understandable that the measurement based on the acquisition price or on the allocation of the total acquisition price. Similarly, judging from the equal nature of InGG and InGG, the same measurement basis is applied for InGIA as well.

For the purpose of more accurate measurement of the fair value of InGIA, they are grouped as follows:
(ba) InGIA which have legal protection – copy rights and similar rights, industrial property items – patents, trademarks, etc.;
(bb) InGIA which do not have legal protection – know-how, results of research and development activities, marketing positions, employees' experience and qualifications, etc.
c) InGG is disclosed as a Note to the Annual Financial Statements, without being included as a value in the Balance sheet.

At this stage of development of the regulatory framework, the author considers that the disclosure of InGG should be made by means of an appropriate document as an enclosure/note to the annual financial statements without the value of InGG being included as a value in the Balance sheet. The disclosure, however, should be by all means made.

The arguments to offer this method of disclosing InGG are:
(ca) the offered method can be integrated in the practice fairly quickly and there will not be necessary any fundamental changes to the conceptual framework of the regulation, which would cause serious opposition;
(cb) the method offered would substantially improve the information significance of Annual Financial Statements and it might be successfully used by the management and investors;
(cc) To start with, the introduction of this type of disclosure can be made without the issuance of any regulations on behalf of the regulatory authority, only based on the inclusion of this requirement for voluntary disclosure into the accounting policy. The accounting policy is an effective instrument for innovations in accounting that might increase its effectiveness as an instrument for entity's management.
Based on these three principles, a set of tools for measuring InGG as a residual value has been elaborated under the project.

Approach C, based on market capitalization, is a modification of the approach based on the residual value. It uses the capitalization of the stock exchange for the purpose of evaluation of company's worth, instead of the value of the direct purchase transaction.
The information about goodwill, including InGG, has to be present in the annual financial statements of those companies listed on the stock exchange. According to the currently effective regulatory framework on accounting and on stock exchange, goodwill, including InGG, does not find any reflection in the annual financial statements. Annual financial statements are considered to be the main source of information for shareholders, investors and other stakeholders, who need to analyze entities in order to invest in their shares. The information about market capitalization of a company, and the degree to which goodwill is presented in it, are an important analytical element to evaluate company's worth and to make investment decisions.

The approach based on market capitalization has been used by Bloom for the evaluation of InGG. The final outcome was that he made a suggestion to issue MCS (Market capitalization statement) of the entity, by means of which the information on InGG is determined and presented.

In the research, the author makes further elaboration of Bloom's approach, in two directions:

- provision of even more detailed information particularly about InGIA, which generate InGG with their synergetic interaction with entity's remaining assets;
- application of this approach for entities not listed on the stock exchange as well by using independent assessor's evaluation based on IVS instead of market capitalization the evaluation of which must involve the application of market analogues method taken from the stock exchange.

The MCS method further developed by the author is designated as MCS plus, MCS plus (a) and MCS plus (b) for the respective directions.
a) MCS plus (a) can be illustratively presented as follows:

Current value of the equity in the Balance sheet

	Current year ($ 000)	Prior year ($ 000)
Registered capital	40 000	38 000
Reserves	10 000	10 000
Accumulated profit	20 000	15 000
	70 000	63 000
Minus: the value of goodwill and other purchased identifiable intangible assets	20 000	18 000
Net fixed assets	50 000	45 000

Market capitalization statement

Number of shares issued	150 000	140 000
Market price of a single share ($)	1	0.8
Market capitalization, which involves:	150 000	112 000
Identifiable intangible assets (IIA) according to balance sheet		
Patents	3 000	4 000
Agreements with suppliers	5 000	5 000
Licenses	2 000	1 500
Technologies	4 000	6 000
Total IIA	14 000	16 000
IA off the Balance sheet (invested, evaluated and voluntarily disclosed in connection with InGG)		
Know-how	20 000	10000
Technologies	12 000	5000
Customer lists	8 000	3000
Other	10 000	2000
Total IA off the Balance	50 000	20000
Goodwill	36 000	31000
Including InGG	6 000	2000
InGG	30 000	29000
Total intangible assets	100 000	67 000
Net tangible assets (according to balance sheet)	50 000	45 000
Market capitalization	150 000	112 000
Analysis of market capitalization	%	%
Identifiable IA according to Balance sheet	9.34	14.29

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- have to allow the evaluation of InGG of maximum number of companies (quoted or not quoted in the stock exchange) with minimum costs;
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The first approach, approach A, stems directly from the nature of InGG, but in this approach the spotlight falls on the method of determining InGIA, which are at the bottom of synergy generation. The principal method of determining the value of InGIA[20] is the calculation of prime cost.

The second approach, approach B, originates directly from the nature of InGG, i.e. synergetic effect, the value of which is determined as the difference between company's acquisition price and the fair value of the net assets.
The third approach, approach C, is a modification of the first approach, because it has the same logics for determining the value of InGG, but it involves the market methods for determining company's worth and specifically the market capitalization. That is why, it has the right of individual existence. This method is applicable for entities listed on stock exchange.

Approach A, for determining InGIA as synergetic factors of InGG is necessary for the purpose of evaluating InGIA in order to subtract their value from company's net worth (together with the value of the net assets), to get the synergetic value of the interaction of assets, which is assumed as a goodwill value. The objective determining of the value of InGG is dependent on the objective identification and determining of the value of InGIA. On the other hand, intangible assets are at the root of the generation of InGG, therefore, it is required to make a specific examination.

In author's point of view, the recognition criteria, in the current regulatory framework concerning the recognition of intangible assets, are too restrictive and impede the recognition of many intangible assets, especially of InGIA. No one in the business practice would make expenses which wouldn't bring economic benefits. That is an imminently inherent feature of business – business risks and exists because risky activities bring earnings higher than the capital investing opportunities of no or low risk. Therefore, it is used for the purposes of determining InGIA, their subordination according to their significance and the criterion of greatest significance has to be (1) ability to generate future benefits, then (2) measurability of asset's value, (3) controllability and (4) identifiability. We specify the first two criteria as "strict" criteria for the identification of InGIA. The last two criteria are determined as "non-strict".

In connection with *approach A* set out above, we can make the following summary:
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[20] InGIA – internally generated intangible assets

b) a conceptual framework of the approach is offered, which facilitates the further specification of the instrumentarium of the approach;
c) the cost method is the main method within the approach, and some “calculation elements” are offered in the conceptual framework, which reflect the status of InGIA. The status generally involves the circumstance, whether the InGIA is protected against encroachments of third parties, and more particularly, whether the access of such parties to the usage of the economic benefits is restricted.

Approach B, based on residual value, is based on the fact that ExGG and InGG are similar by nature. It is proven that unequal treatment of internally and externally generated goodwill, when being evaluated, does not reflect the objective economic environment and is a generator of negative effects in the economy and undermines economic growth. In order to avoid such negative effects, it is necessary that InGG is considered equal in status to ExGG, and the information about entity’s InGG should be presented to the management and investors, regardless of the regulatory provisions.

The conceptual framework of the approach is depicted by three main principles:
a) Entities which have not performed business combinations, i.e. InGG needs to be calculated for them, can be distinguished into three groups:
(aa) entities listed on the stock exchange;
(ab) entities which are not listed on the stock exchange, but are well placed on the market, and are profitable and stable in their development;
(ac) entities, which are not listed on the stock exchange and do not meet the stability requirements.
b) Evaluation of InGIA the value of which is deducted from the residual value. They are measured at fair value, the same as with InGG.

The need of the evaluation of InGIA arises from the fact that InGG increases when InGIA are not recognized and reported. The non-recognition of InGIA “artificially/falsely” increases the value of InGG. Therefore, similar to the approach with ExGG, the right to evaluate InGIA should be applied for InGG as well, so that the residual value could be reduced by them. Thus, the monetary expression of InGG will become objective and fair.

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For the purpose of more accurate measurement of the fair value of InGIA, they are grouped as follows:
(ba) InGIA which have legal protection – copy rights and similar rights, industrial property items – patents, trademarks, etc.;
(bb) InGIA which do not have legal protection – know-how, results of research and development activities, marketing positions, employees’ experience and qualifications, etc.
c) InGG is disclosed as a Note to the Annual Financial Statements, without being included as a value in the Balance sheet.

At this stage of development of the regulatory framework, the author considers that the disclosure of InGG should be made by means of an appropriate document as an enclosure/note to the annual financial statements without the value of InGG being included as a value in the Balance sheet. The disclosure, however, should be by all means made.

The arguments to offer this method of disclosing InGG are:
(ca) the offered method can be integrated in the practice fairly quickly and there will not be necessary any fundamental changes to the conceptual framework of the regulation, which would cause serious opposition;
(cb) the method offered would substantially improve the information significance of Annual Financial Statements and it might be successfully used by the management and investors;
(cc) To start with, the introduction of this type of disclosure can be made without the issuance of any regulations on behalf of the regulatory authority, only based on the inclusion of this requirement for voluntary disclosure into the accounting policy. The accounting policy is an effective instrument for innovations in accounting that might increase its effectiveness as an instrument for entity's management.
Based on these three principles, a set of tools for measuring InGG as a residual value has been elaborated under the project.

Approach C, based on market capitalization, is a modification of the approach based on the residual value. It uses the capitalization of the stock exchange for the purpose of evaluation of company's worth, instead of the value of the direct purchase transaction.
The information about goodwill, including InGG, has to be present in the annual financial statements of those companies listed on the stock exchange. According to the currently effective regulatory framework on accounting and on stock exchange, goodwill, including InGG, does not find any reflection in the annual financial statements. Annual financial statements are considered to be the main source of information for shareholders, investors and other stakeholders, who need to analyze entities in order to invest in their shares. The information about market capitalization of a company, and the degree to which goodwill is presented in it, are an important analytical element to evaluate company's worth and to make investment decisions.

The approach based on market capitalization has been used by Bloom for the evaluation of InGG. The final outcome was that he made a suggestion to issue MCS (Market capitalization statement) of the entity, by means of which the information on InGG is determined and presented.

In the research, the author makes further elaboration of Bloom's approach, in two directions:
- provision of even more detailed information particularly about InGIA, which generate InGG with their synergetic interaction with entity's remaining assets;
- application of this approach for entities not listed on the stock exchange as well by using independent assessor's evaluation based on IVS instead of market capitalization the evaluation of which must involve the application of market analogues method taken from the stock exchange.

The MCS method further developed by the author is designated as MCS plus, MCS plus (a) and MCS plus (b) for the respective directions.
a) MCS plus (a) can be illustratively presented as follows:

Current value of the equity in the Balance sheet

	Current year ($ 000)	Prior year ($ 000)
Registered capital	40 000	38 000
Reserves	10 000	10 000
Accumulated profit	20 000	15 000
	70 000	63 000
Minus: the value of goodwill and other purchased identifiable intangible assets	20 000	18 000
Net fixed assets	50 000	45 000

Market capitalization statement

Number of shares issued	150 000	140 000
Market price of a single share ($)	1	0.8
Market capitalization, which involves:	150 000	112 000
Identifiable intangible assets (IIA) according to balance sheet		
Patents	3 000	4 000
Agreements with suppliers	5 000	5 000
Licenses	2 000	1 500
Technologies	4 000	6 000
Total IIA	14 000	16 000
IA off the Balance sheet (invested, evaluated and voluntarily disclosed in connection with InGG)		
Know-how	20 000	10000
Technologies	12 000	5000
Customer lists	8 000	3000
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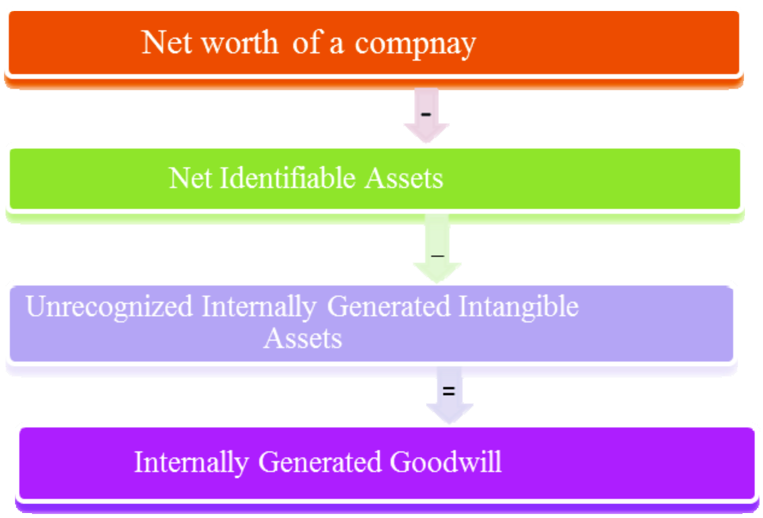
Total IA off the Balance	50 000	20000
Goodwill	36 000	31000
Including InGG	6 000	2000
InGG	30 000	29000
Total intangible assets	100 000	67 000
Net tangible assets (according to balance sheet)	50 000	45 000
Market capitalization	150 000	112 000
Analysis of market capitalization	%	%
Identifiable IA according to Balance sheet	9.34	14.29

IA off the Balance sheet	33.33	17.86
Goodwill	24	27.67
Including InGG	4	1.78
InGG	20	25.89
Net tangible assets	33.33	40.18
	100	100

b) Any further development of the method MCS plus (b) is applicable only for the entities not listed on the stock exchange.
With regard to the entities not listed on the stock exchange, the evaluation based on the market capitalization is replaced by entity's valuation made by an independent assessor pursuant to IVS. One of the valuation methods of independent assessors must be the method of market comparison (market analogues). In this case a market analogue can be most easily found on the stock exchange (that is why the further development of the method is adjoined to the MCS method).

CONCLUSION

a) The usage of these three approaches can be presented in the following diagram:



b) The main thesis of this research is that the internally generated goodwill is the basic factor for the economic development of the company and it has to be recognized, reported and disclosed in accounting by means of appropriate methods and approaches so that the economic growth could be adequately (effectively and efficiently) managed and not become invisible for the users of financial information. A system of three approaches for reporting an disclosing of InGG was offered.
c) The first approach concerns the determining of InGIA as synergetic factors of InGG. This approach focuses on the method of determining InGIA which are at the bottom of synergy generation.
d) The second approach based on residual value allows evaluating InGG, from the perspective of the fundamental position that the nature of InGG and ExGG is the same.
e) The third approach is based on market capitalization. A further development of Bloom's method has been made which provides for the more precise determining and disclosing of

InGG for the entities listed on the stock exchange. The further development of the method is designated as MCS plus (a).

f) Bloom's method is further developed as well and it is applicable for the entities not listed on the stock exchange by using the valuation of an independent assessor instead of narket capitalization, taking into account that this valuation must on a mandatory basis involve the valuation method using market analogues. This further development is designated as MCS plus (b).

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