

Building blocks of corporate accounting: goodwill

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Edelweiss Capital

In the tapestry of financial reporting, there's something akin to a magic word that gets tossed around, yet often escapes our day-to-day scrutiny: goodwill. It's not about friendly gestures or benevolent acts in business. No, it's an accounting concept that can be as elusive as it is pivotal. "Company A's massive goodwill from recent acquisitions", "Company B's surprising goodwill impairment" – such statements may flash across financial news, but what's the story behind them? Sometimes, it's the hidden figures that hold the key.

Embarking on a new journey in our series, we're rolling up our sleeves to delve into the heart of goodwill. It's more than just numbers on a balance sheet; it's about the essence of acquisitions, the subtleties of value, and the very character of corporate management. Not everything wrapped in a balance sheet is as it appears.

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Nature morte aux livres "Still Life with Books and a Violin". Jan de Heem (1606–1684)

Goodwill is an intangible asset that arises when one company acquires another for a price higher than the fair market value of its net identifiable assets. This premium represents the value of a company's brand reputation, customer relationships, intellectual property, and other intangible factors that do not have a specific monetary value on the books. It's a reflection of the value that the buying company sees in the target's future earnings potential, synergies, or strategic positioning.

When Facebook acquired Instagram for \$1 billion in 2012, the tangible and identifiable intangible assets were valued far below the purchase price. The difference was recorded as goodwill, reflecting the perceived value of Instagram's user base and growth potential.

In financial reporting, goodwill serves as a vital indicator of a company's strategic decisions and how those decisions are playing out over time. It offers insights into the management's ability to leverage acquisitions for growth, the success (or failure) of merger integrations, and the sustainability of the company's competitive advantages. Goodwill, being subject to potential impairment, can also signal underlying problems with an acquisition or with the broader business landscape, reflecting changes in market conditions, competition, or other factors that reduce the perceived value of the acquired assets.

Changes in Accounting Standards

Historically, goodwill was treated as an asset that needed to be amortized over a period, often 40 years. This amortization would reduce the value of goodwill on the balance sheet gradually, reflecting the idea that the value of intangible assets diminishes over time.

Before the adoption of FASB Statement No. 142 in the U.S., companies like IBM and General Electric would amortize goodwill over a fixed period. This had significant tax implications and affected net income reporting.

With the introduction of new accounting standards like IFRS 3 and ASC 350 in the U.S., the practice of amortizing goodwill has largely been replaced with annual impairment testing. This means that instead of automatically reducing the value of goodwill over time, companies must **assess** whether the value of the intangible assets associated with goodwill has been diminished. If so, an impairment charge is recorded to write down the value.

This shift in how goodwill is accounted for represents a more nuanced and realistic view of how intangible assets retain or lose value over time. *Note, however, that they never increase. Instagram is now far more valuable than when Facebook acquire it, but the goodwill valuation in the balance sheet remains the same.*

The move from amortizing to impairment testing reflected an understanding that the value of goodwill doesn't necessarily diminish in a linear fashion and that market conditions, management decisions, and other factors can cause sudden changes in value.

A counterpart to this change is that goodwill impairment is no longer deductible from the taxable base for taxes. In other words, no impairment will reduce your taxes because your accounting profit is lower.

Impairment of Goodwill

Goodwill impairment occurs when the carrying value of goodwill exceeds its fair value, meaning that the intangible assets associated with goodwill have lost value. This necessitates a write-down of the goodwill's value on the company's balance sheet.

Several conditions might lead to goodwill impairment, such as changes in market conditions, new competition, regulatory changes, or negative changes in the use of underlying assets.

In 2012, Microsoft recorded a \$6.2 billion impairment charge related to the goodwill of its Online Services Division, largely attributed to the underperformance of the aQuantive acquisition.

Sprint's 2008 goodwill impairment of \$29.7 billion was a result of fierce competition and regulatory challenges that led to a reevaluation of its brand and customer relationships' worth.

When impairing goodwill, companies must recognize a non-cash charge on their income statement, reducing net income. On the balance sheet, the carrying value of goodwill is reduced by the impairment amount.

Impairing goodwill has its benefits and drawbacks.

Pros:

Transparency: Reflects the actual value of intangible assets, providing more accurate information to investors.

Cons:

- **Earnings Impact:** The impairment charge can significantly reduce reported earnings, leading to a potential drop in stock price.
- **Perception of Failure:** Large impairments may signal mismanagement or overpayment for acquisitions, affecting investor and market confidence.

What management would want to acknowledge a mistake in an acquisition or a loss (even if it's non-cash) in front of their investors in the name of transparency?

Sounds like a joke, right?

Well, they are supposed to have auditors checking their impairment checks to provide a fair valuation, but sadly, as we will see below, they are not very effective...

Impact on Financial Metrics

Effects on Profitability

This is a very clear one: impairing goodwill has a direct impact on a company's reported profits. And we all know how much Wall Street loves earnings...

Impact on Return Ratios

The impairment of goodwill may paradoxically improve certain financial ratios like Return on Equity (ROE) and Return on Invested Capital (ROIC). Despite leading to reported losses, the reduction in assets (due to the impairment) may increase these return ratios, making the company appear more efficient in its use of capital.

HP's \$8.8 billion impairment related to its acquisition of Autonomy led to a significant loss in 2012. However, the impairment also improved ROE, as the equity base was reduced.

Goodwill and Management Reporting

Management might strategically use goodwill impairment to their advantage. Impairing goodwill at a particular time might align with other business strategies, such as restructuring or during a period of broader market downturn. Imagine a CEO having his stock options awards tied to a certain ROE and cash flow generation. An impairment in goodwill, even if not a great PR, will get him closer to his financial targets!

In 2016, ConocoPhillips strategically impaired \$9.3 billion of goodwill during a period of low oil prices. This allowed the company to recognize the loss during a time when the industry as a whole was struggling, potentially masking underlying performance issues.

Counter-example: Some companies might delay goodwill impairment to avoid the appearance of weakness, potentially leading to questions about the accuracy and integrity of their financial reporting.

The way goodwill is treated on financial statements can offer a window into management's decisions, assumptions, and strategic planning. Accounting for goodwill involves significant judgment and assumptions, and the way it is managed can indicate the management's perspective on the long-term value of acquired assets.

The presence or absence of goodwill impairment might indicate potential issues or discrepancies within management's actions. A failure to impair goodwill when conditions warrant can be a sign of over-optimism or even an attempt to artificially inflate the company's financial position.

Examining Goodwill Through Annual Reports

There's no clear structure for how companies must present their impairment tests in the annual report, so each one does as it pleases. Most don't provide any information about the assumptions they make, and those that do probably expect no one to read it. Next, we will explore what three companies report and the insights we can glean from their comments.

Case Study 1 - Nagarro (\$NA9)

Nagarro is a German/Indian company providing digital engineering services. The company lived strong tail-winds after the pandemic, leading to high levels of organic growth, but also a series of not so cheap acquisitions. In its annual report, the company discloses its goodwill impairment test:

	Goodwill		Goodwill
	kEUR		kEUR
Gross carrying amount as at Jan 1, 2022	163,401	Gross carrying amount as at Jan 1, 2021	95,87€
Acquisitions through business combinations	30,497	Acquisitions through business combinations	60,744
Additions	-	Additions	.
Disposals	-	Disposals	.
Currency differences	8,723	Currency differences	6,77€
Gross carrying amount as at Dec 31, 2022	202,622	Gross carrying amount as at Dec 31, 2021	163,401
Accumulated amortization and impairment as at Jan 1, 2022	-	Accumulated amortization and impairment as at Jan 1, 2021	.
Amortization for the year	-	Amortization for the year	.
Impairment	-	Impairment	.
Disposals	-	Disposals	.
Currency differences	-	Currency differences	.
Accumulated amortization and impairment as at Dec 31, 2022	-	Accumulated amortization and impairment as at Dec 31, 2021	.
Net carrying amount as at Dec 31, 2022	202,622	Net carrying amount as at Dec 31, 2021	163,401

Goodwill results from the difference between the purchase costs of interests in business combinations and the fair value of the assets, liabilities, and contingent liabilities of shares in the acquired companies on the acquisition date. With the acquisition of RipeConcepts Group, Techmill Group and BC-Unity in 2022, goodwill of kEUR 30,497 (2021: kEUR 60,744) was recognized. The translation of companies not acquired in euros increased the goodwill by kEUR 8,723 (2021: kEUR 6,779). The currency differences were recognized in the consolidated statements of comprehensive income under other comprehensive income.

Goodwill is subject to regular annual impairment tests or more frequently if events or changes in circumstances indicate that it might be impaired. Nagarro applies the value-in-use method and determines the value-in-use based on a three-year plan for the respective CGUs. For the perpetual period, it extrapolates the cash flows of the third detailed planning year for all other future years. These cash flows are discounted using a weighted average cost of capital (WACC) which are disclosed in the table below. In the planning

phase after the third planning year, the interest rates are reduced by a growth discount of 1 percentage point. The interest rates take into account debt and equity ratios derived from peer group.

The following parameters were incorporated in calculating the WACC rate:

	Dec 31, 2022				Dec 31, 2021			
	North America	Central Europe	Rest of Europe	Rest of the World	North America	Central Europe	Rest of Europe	Rest of the World
Risk free rate	3.38%	2.28%	2.77%	7.72%	2.50%	0.78%	1.52%	6.83%
Equity ratio peer group comparison	78.07%	78.07%	78.07%	78.07%	80.75%	80.75%	80.75%	80.75%
Debt ratio peer group comparison	21.93%	21.93%	21.93%	21.93%	19.25%	19.25%	19.25%	19.25%
Beta (unlevered)	0.9996	0.9996	0.9996	0.9996	1.0200	1.0200	1.0200	1.0200
Tax rate	26.00%	28.79%	21.72%	29.57%	27.00%	28.93%	20.93%	30.00%
Interest rate on debt	5.50%	2.00%	3.39%	9.50%	3.58%	2.10%	1.04%	8.84%
Risk premium for equity	10.55%	9.71%	11.02%	23.60%	8.13%	6.00%	7.20%	16.45%
WACC pre-tax	9.44%	8.02%	9.34%	20.51%	7.25%	5.25%	6.02%	14.99%
WACC after tax	9.13%	7.89%	9.18%	19.89%	7.06%	5.13%	5.97%	14.48%

Never forget: the WACC is also the opportunity cost of your capital for these investments... Does it make sense to discount a European company at a lower discount rate than a similar one in the US, independently of the central banks' interest rates? Food for thought.

The following growth rates have been applied:

	North America	Central Europe	Rest of Europe	Rest of the World
Growth rates 2022				
Average annual revenue growth in %	18.7	19.5	19.8	21.9
Growth rates 2021				
Average annual revenue growth in %	23.5	20.9	20.1	20.6

	North America	Central Europe	Rest of Europe	Rest of the World
	kEUR	kEUR	kEUR	kEUR
Dec 31, 2022				
Book value	158,217	27,444	369	16,591
Value in use	344,801	189,451	57,309	50,610
Dec 31, 2021				
Book value	126,340	27,299	390	9,371
Value in use	230,915	232,664	133,812	57,754

With these assumptions, no wonder the value in use (the present value of future cash flows) is higher than their book value. I leave all of you to draw your own interpretation of the assumptions taken and if you would model the value of any of your companies the same way.

With the growth slowdown this year and the rise in interest rates, it will be very interesting to see what emerges from the new impairment test and whether management maintains their assumptions. This could give us a clear reflection of their transparency.

Case Study 2 - JTC plc (\$JTC)

JTC plc is a company providing services to corporations, investment funds and family offices focused on the setup, administration, servicing, and winding up of legal structures.

In this case, the company has been acquiring smaller companies as part of its strategy to consolidate a fragmented industry. Management reports each of the company's acquired business with the respective goodwill, and they detail quite specific the assumptions they do. Note one of the largest acquisitions, SALI, accounting for almost 40% of their goodwill:

21. GOODWILL AND OTHER INTANGIBLE ASSETS (CONTINUED)

21.1. GOODWILL

Goodwill impairment

Goodwill is not amortised but is tested for impairment annually, or more frequently if events or changes in circumstances indicate that the carrying amount may not be recoverable. With the exception of US, goodwill is monitored at a jurisdictional level by Management. Goodwill is allocated to CGUs for the purpose of impairment testing and this allocation is made to those CGUs that are expected to benefit from the business combination in which the goodwill arose. The aggregate carrying amounts of goodwill allocated to each CGU is as follows:

In the current year:	Balance at 1 Jan 2022 £'000	Business combinations £'000	Measurement period adjustments £'000	Exchange differences £'000	Balance at 31 Dec 2022 £'000
CGU	Note				
Jersey		66,104	–	–	66,104
Guernsey		10,761	–	–	10,761
BVI		752	–	–	752
Switzerland		2,366	–	138	2,504
Cayman		224	–	27	251
Luxembourg		27,809	–	1,377	29,186
Netherlands		14,220	–	772	14,992
Dubai		1,763	–	212	1,975
Mauritius		2,379	–	277	2,656
US – NESF		44,387	–	5,317	49,704
US – SALI	31.7	139,573	2,598	(13,437)	15,537
US – Other	31.8	10,603	–	(426)	1,269
US – NYPTC	31.1	–	8,384	–	(322)
Ireland		8,688	–	108	255
UK		11,976	–	18	(1)
Total		341,605	10,982	(13,737)	24,858
					363,708

In the prior year:	Balance at 1 Jan 2021 £'000	Business combinations £'000	Measurement period adjustments £'000	Exchange differences £'000	Balance at 31 Dec 2021 £'000
CGU					
Jersey		66,569	–	(465)	66,104
Guernsey		10,761	–	–	10,761
BVI		752	–	–	752
Switzerland		2,400	–	(34)	2,366
Cayman		222	–	2	224
Luxembourg		29,721	–	(1,912)	27,809
Netherlands		15,292	–	(1,072)	14,220
Dubai		1,746	–	17	1,763
Mauritius		2,357	–	22	2,379
US – NESF		43,957	–	430	44,387
US – Other		–	151,724	–	(1,548)
Ireland		–	8,748	–	(60)
UK		–	11,976	–	11,976
Total		173,777	172,448	(465)	(4,155)
					341,605

Key assumptions used to calculate the recoverable amount for each CGU

The recoverable amount of all CGUs has been determined based on the higher of the value in use calculation and fair value less cost to sell. Projected cash flows are calculated with reference to each CGU's latest budget and business plan which are subject to a rigorous review and challenge process. Management prepare the budgets through an assessment of historical revenues from existing clients, the pipeline of new projects, historical pricing, and the required resource base needed to service new and existing clients, coupled with their knowledge of wider industry trends and the economic environment.

The year 1 cash flow projections are based on the latest approved budget and years 2 to 5 on detailed outlooks prepared by Management, except for the recently acquired US – SALI CGU, which covers a 10 year period due to the significantly longer useful economic life of its customer relationships.

Previously, the terminal growth rate was based on expected long-term inflation. This has been updated to also consider the long-term average growth rate for the jurisdiction and services provided.

Management estimate discount rates using pre-tax rates that reflect current market assessments of the time value of money. In assessing the discount rate applicable to the Group, the following factors have been considered:

- Long-term treasury bond rate for the relevant jurisdiction
- The cost of equity based on an adjusted Beta for the relevant jurisdiction
- The risk premium to reflect the increased risk of investing in equities

Management have given due consideration to climate change and any potential impact on projected cash flows. Such is the nature of JTC's business and the diversification of customer relationships that Management have concluded the impact to be immaterial to each CGU's recoverable amount.

A summary of the values assigned to the key assumptions used in the value in use calculations are as follows:

- Revenue growth rate: up to 56.1%
- Terminal value growth rate: between 0.5% and 4.0%
- Discount rate: between 10.5% and 15.3%

The key assumptions used for CGUs where the carrying amount is a significant proportion of the total carrying value of goodwill is as follows:

CGU	% of total carrying value of goodwill	Average annual revenue growth rate		Terminal value growth rate		Discount rate	
		2022	2021	2022	2021	2022	2021
Jersey	18.2%	7.6%	2.7%	2.5%	0.0%	11.2%	10.6%
Luxembourg	8.0%	10.9%	7.9%	2.0%	1.5%	11.4%	12.4%
US – NESF	13.7%	17.1%	19.0%	3.0%	3.0%	11.3%	11.4%
US – SALI	39.7%	17.2%	–	4.0%	–	10.5%	–

Conclusion

The recoverable amount of goodwill determined for each CGU as at 31 December 2022 was found to be higher than its carrying amount.

As you can see, the carrying value of goodwill for SALI is justified by a 10 years expected CAGR of 17.2% and later, a terminal value growth rate of 4%...

Case Study 3 - ICON plc (ICLR 0.00%↑)

ICON plc is one of the largest clinical research organization (CRO). What I found interesting about this case was comparing the assumptions they did at the end of 2021 and the ones in 2022:

Notes to Consolidated Financial Statements (continued)
for the year ended 31 December 2021

13. Intangible assets - goodwill and other (continued)
Impairment review of goodwill

Goodwill is subject to impairment testing on an annual basis, or more frequently if there are indicators of impairment. These assets are allocated to groups of cash generating units (CGUs). The recoverable amount of each of the CGUs is determined based on value-in-use calculations. Goodwill acquired through business combinations has been allocated to the Group's three CGUs. The CGUs identified represent the lowest level within the Group at which goodwill is monitored and are not larger than the operating segment determined in accordance with IFRS 8 Operating Segments.

The Group has identified three CGUs (2020: one) in accordance with the provisions of IAS 36 Impairment of Assets. Following the Merger, the Group has revaluated its CGUs resulting in the increase from one CGU in 2020 to three CGUs in 2021.

A summary of the allocation of the carrying value of goodwill by CGU, is as follows:

	31 December 2021	31 December 2020
	\$'000	\$'000
Goodwill*		
Clinical Research	6,232,151	950,267
Strategic Solutions	2,040,521	—
Data Solutions	817,389	—
	9,090,061	950,267

* The goodwill associated with the Merger has been provisionally allocated to the CGUs above and is subject finalisation in 2022

Impairment testing methodology and results

Cash flow forecasts employed for the value-in-use calculations are for a five year period approved by management and a terminal value which is applied to the year five cash flows. The terminal value reflects the discounted value of the cash flows beyond year five which is based on the weighted average long-term growth rates for each CGU.

Management's estimates of future cash flows are based upon current budgets and strategic plans and are reflective of anticipated growth rates within the CRO industry, expected growth in the Group's market share and reflective of past experience. Key assumptions applied in determining expected future cash flows for these plans include management's estimate of future profitability, replacement capital expenditure requirements, trade working capital investment needs and tax considerations. The Group's cash flow projections are adjusted each year for actual and expected changes in performance.

The following assumptions were applied in determining the five year projected cash flows of the three CGUs at 31 December 2021:

	31 December 2021		
	Clinical Research	Strategic Solutions	Data Solutions
Expected revenue growth rate	7.0%	7.0%	7.0%
Expected growth rate for operating costs	6.5%	6.5%	6.5%
Expected effective tax rate	15% - 16.5%	15% - 16.5%	15% - 16.5%
Expected annual working capital growth rate	2.0%	2.0%	2.0%
Expected capital expenditure growth rate	2.0%	2.0%	2.0%
Discount rate	11.6%	11.6%	12.1%
Long term growth	3.0%	3.0%	3.0%

Notes to Consolidated Financial Statements (continued)
for the year ended 31 December 2022

13. Intangible assets - goodwill and other (continued)
Impairment review of goodwill

Goodwill is subject to impairment testing on an annual basis, or more frequently if there are indicators of impairment. These assets are allocated to groups of cash generating units (CGUs). The recoverable amount of each of the CGUs is determined based on value-in-use calculations. Goodwill acquired through business combinations has been allocated to the Group's three CGUs. The CGUs identified represent the lowest level within the Group at which goodwill is monitored and are not larger than the operating segment determined in accordance with IFRS 8 Operating Segments.

The Group has identified three CGUs in accordance with the provisions of IAS 36 Impairment of Assets.

A summary of the allocation of the carrying value of goodwill by CGU, is as follows:

	31 December 2022	31 December 2021
	\$'000	Revised* \$'000
Goodwill		
Clinical Research	7,284,244	7,307,655
Strategic Solutions	1,372,648	1,377,059
Data Solutions	367,587	368,768
	9,024,479	9,053,482

* The comparatives have been revised for IFRS 3 measurement period adjustments. Refer to note 14 for further details.

Impairment testing methodology and results

Cash flow forecasts employed for the value-in-use calculations are for a five year period approved by management and a terminal value which is applied to the year five cash flows. The terminal value reflects the discounted value of the cash flows beyond year five which is based on the weighted average long-term growth rates for each CGU.

Management's estimates of future cash flows are based upon current budgets and strategic plans and are reflective of anticipated growth rates within the CRO industry, expected growth in the Group's market share and reflective of past experience. Key assumptions applied in determining expected future cash flows for these plans include management's estimate of future profitability, replacement capital expenditure requirements, trade working capital investment needs and tax considerations. The Group's cash flow projections are adjusted each year for actual and expected changes in performance.

The following assumptions were applied in determining the five year projected cash flows of the three CGUs at 31 December 2022:

	31 December 2022		
	Clinical Research	Strategic Solutions	Data Solutions
Expected revenue growth rate	8.3%	7.8%	7.8%
Expected growth rate for operating costs	8.4%	8.6%	7.7%
Expected effective tax rate	15.5%	15.5%	15.5%
Expected annual working capital growth rate	19.0%	(3.2)%	—%
Expected capital expenditure growth rate	10.9%	11.9%	15.5%
Discount rate	11.5%	11.5%	11.5%
Long term growth	2.0%	2.0%	2.0%

There could be many things to comment on here because there are some astonishing changes in the estimations, but note: one might think it makes sense for companies to use a higher discount rate in the current interest rate environment. However, in this goodwill impairment test, it has surprisingly decreased.

Goodwill is like the hidden narrative in a company's financial story. It may seem abstract or complex, but its proper examination can lead to profound insights. Whether it's a clue to management's confidence or a warning sign of underlying problems, goodwill is a key player in the complex game of business valuation and analysis.

Remember, in finance, as in life, a holistic perspective is often the key to understanding. Goodwill is just another arrow in our quiver, highlighting the importance of considering all facets of a company's financial landscape when making investment decisions.