Johnson and Petrone (1998, p. 295) identified six components of goodwill:

1. *Excess of the fair values over the book values of the acquiree’s recognized assets.* In a business acquisition, as assets acquired are measured at fair value, these excesses should not exist. Subsequent to the acquisition, the acquiree’s goodwill could include such excesses where assets are measured at cost.

2. *Fair values of other net assets not recognized by the acquiree.* The assets of concern here are those tangible assets which are incapable of reliable measurement by the acquiree, and non-physical assets that do not meet the identifiability criteria for intangible assets.

3. *Fair value of the ‘going concern’ element of the acquiree’s existing business.* This represents the ability of the acquiree to earn a higher return on an assembled collection of net assets than would be expected from those net assets operating separately. This reflects synergies of the assets, as well as factors relating to market imperfections such as an entity’s ability to earn a monopoly profit, or where there are barriers to competitors entering a particular market.

4. *Fair value from combining the acquirer’s and acquiree’s businesses and net assets.* This stems from the synergies that result from the combination, the value of which is unique to each combination.

5. *Overvaluation of the consideration paid by the acquirer.* This relates to errors in valuing the consideration paid by the acquirer, and may arise particularly where shares are issued as consideration with differences in prices for small parcels of shares as opposed to controlling parcels of shares. There could also be overvaluation of the fair values of the assets acquired. This component could then relate to all errors in measuring the fair values in the business combination.

6. *Overpayment (or underpayment) by the acquirer.* This may occur if the price is driven up in the course of bidding; conversely, goodwill could be understated if the acquiree’s net assets were obtained through a distress or fire sale.

In paragraph BC130 of the Basis for Conclusions on IFRS 3, the IASB recognized that components 1 and 2 above are not conceptually part of goodwill. Johnson and Petrone (1998, p. 295) and the IASB (paragraph BC131) recognized that components 5 and 6 in the above list also are not conceptually part of goodwill, but rather relate to measurement errors. The two components that are seen as part of goodwill are components 3 and 4, described by Johnson and Petrone (p. 296) as ‘going-concern
goodwill’ and ‘combination goodwill’ respectively, with the combination of the components being referred to as ‘core goodwill’. This is represented diagrammatically in Figure 1.

![Diagram of Components of Goodwill]

**Figure 1:** Core goodwill

Source: Data derived from Johnson and Petrone (1998).

It is this ‘core goodwill’ that the IASB is concerned with in determining how to account for goodwill. The IASB in paragraph BC137 of the Basis for Conclusions on IFRS 3 note how IFRS 3 tries to avoid subsuming the first, second, and fifth components into the amount calculated as goodwill by requiring an acquirer to make every effort to:

- measure the consideration accurately (eliminating or reducing component 5)
- recognize the identifiable net assets acquired at their fair values rather than their carrying amounts (eliminating or reducing component 1)
- recognize all acquired intangible assets (reducing component 2).

**Is goodwill an asset?**

IFRS 3 accounts for goodwill as an asset. Whether core goodwill is an asset is considered in detail in Johnson and Petrone (1998, pp. 296–302) and in Miller and Islam (1988). There are many other articles in the accounting literature that discuss this issue, because it has been a source of much debate. Of the accounting standard-setting bodies that have considered the issue, the Accounting Standards Board in the United Kingdom in 1997, in its Financial Reporting Standard 10 *Goodwill and Intangible Assets*, took the view that goodwill is not an asset (Summary, paragraph b):

Goodwill arising on acquisition is neither an asset like other assets nor an immediate loss in value. Rather, it forms the bridge between the cost of an investment shown as an asset in the acquirer’s own financial statements and the values attributed to the acquired assets and liabilities in the consolidated financial statements. Although purchased goodwill is not in itself an asset, its inclusion amongst the assets of the
reporting entity, rather than as a deduction from shareholders’ equity, recognizes that goodwill is part of a larger asset, the investment, for which management remains accountable.

As defined in the *Framework*, an asset has essentially three characteristics: (1) expected future economic benefits, (2) control by the owner over the benefits, and (3) the benefits arise as the result of a past event. There is little debate over whether goodwill is a repository of expected future economic benefits, as this is evidenced by the fact that the acquirer has been prepared to pay extra consideration over and above an amount equal to the fair value of the acquiree’s identifiable net assets. Similarly, the existence of the business combination is seen as a past event. The key area of debate is whether the entity has control over the benefits.

It is argued there that the IASB, because of the debates over whether items such as well-trained employees or marketing outlays are assets, introduces the identifiability criterion to ensure that the only items recognized as intangible assets are those that are separable or arise from contractual or other legal rights. Paragraph BC323 of the Basis for Conclusions on IFRS 3 recognizes that goodwill arises in part because of factors such as having a well-trained workforce and loyal customers not being seen as controllable by the entity and therefore not being assets.

The problem with goodwill is that it is a unique asset. It arises as a residual. As Leo, Hoggett, and Radford (1995, pp. 44–7) noted, the key difference between identifiable net assets and goodwill is measurement:

The difference between the measurement method used for goodwill and that for measurement of all other assets of the business is whether the method involves determining the value of the business as a whole or part thereof.

The authors defined unidentifiable assets as those assets that meet the recognition criteria and cannot be measured without measuring the total net assets of a business entity. The existence of goodwill depends on the measurement of the entity as a whole. In recognizing this, the IASB argued in paragraph BC323 of the Basis for Conclusions on IFRS 3:

Control of core goodwill is provided by means of the acquirer’s power to direct the policies and management of the acquiree. Therefore, both the IASB and the FASB concluded that core goodwill meets the conceptual definition of an asset.
References


