

THE PARADOX OF GOODWILL: WHY DO WE PAY MORE THAN THE FAIR VALUE? STUDY ON ROMANIAN COMPANIES

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Abstract:

Romanian economy of the last 20 years has been marked by numerous privatization processes. The goodwill is an unidentifiable intangible asset, which raised the interest of many accounting researchers. In this paper, we aimed to analyze the annual financial statements of the foreign companies that bought Romanian companies with the purpose of identifying the value of the goodwill and of other intangible assets acknowledged after the transaction, considering that this value is an important clue concerning the intangible capital of Romanian companies.

Key words: intangible assets, goodwill, intangible capital, privatization.

JEL classification: M41, G34

Introduction

Specialized literature in accounting and management underlines, ever more often, the fact that in the knowledge society the main role in insuring the competitive advantage on the long term is played by intangible assets, innovation, knowledge, and intangible assets.

Looking retrospectively, in our study we focused on the privatization processes that took place in Romania after 1996, with the purpose of identifying the value of the transactions and of the goodwill and, possibly, other intangible assets, acknowledged by the buying companies.

Literature review

Sahut et. al. (2011) prove, in a recent study, that the adoption of the International Accounting Standards generated changes in the accounting value of European companies: many companies included in the value of the goodwill the intangible assets that did not meet the criteria stipulated in IAS 38, but performed additional re-evaluations of the intangible goods, in order to comply with the international accounting norms. It seems that the investors fully understood the advantages of capitalizing upon the intangible elements, to the detriment of their acknowledgement as expenses for the period. Also, Sahut, Boulerne and Teulon consider that the standardization bodies met their objective through the application of IAS 38, increasing the degree of confidence in the information regarding intangible assets, as a result of the capitalization criteria imposed.

Intangible assets and especially the goodwill are frequently encountered elements in consolidated financial statements.

The complexity of intangible assets is widely debated in specialized literature, most accounting researchers considering that they are one of the most controversial subjects in accounting: Wines and Ferguson, 1993; Jennings et al., 1996; Choi et al., 2000; Alferdson, 2001; Godfrey and Koh, 2001 (Lhaopadchan, 2010).

One of the most controversial intangible assets is the goodwill. The main recommendations regarding the combinations of companies included in the US GAAP

(SC 805, *Business Combinations*) and IFRS (IFRS 3(R), *Business Combinations*) are the climax of the convergence project between IASB and FASB. According to ASC 805 and IFRS 3, all the company combinations must be accounted using the acquisition method (Ernst & Young Publications, 2011).

The goodwill, the most usual unidentifiable accounting asset, results after a transaction. According to IFRS 3 “Company combinations”, the goodwill refers to future economic benefits appeared from assets that cannot be identified individually and distinctly acknowledged.

Cohen (2005, pp.91-92) is one of the researchers who attempted to provide an answer to the question: why would a company pay more than the fair value of another company?, identifying three possible reasons: *erroneous identification* (the buyers may consider that some acquisition costs are an investment and not an expense), *erroneous evaluation* (either because there are no comparable intangible assets on the market, or because the present cash flow approach for computing their value is not as appropriate as, for instance, the price of other similar intangible assets, recently sold), and *uncertainty* (the buyer acknowledges the ability of the company they wish to purchase in obtaining unexplainable economic benefits, being willing to pay for unidentifiable intangible assets). This dilemma was called by Cohen *the paradox of goodwill or why do we pay more than the fair value?*

The Imperative of Presenting Information on Intangible Assets

Knowledge is the most important asset of an organization and the key to its survival in the information society (...) An adaptable and intelligent company continuously reconfigures its competences and skills in order to best meet and determine permanent progress in its own vision, objective, and values, as well as in the adopted strategy. Recombining these elements allows a flexible answer of the organization to the changes of the market and of the business environment where it operates (Andone et. al., 2011).

According to DiPiazza et. al. (Watson, 2010), the top managers of the largest six audit companies also suggested that the significant differences between the market values and the accounting values of the companies stress the low relevance of the financial statements drawn based on the criterion of historical cost, and that it is necessary to present information on innovation, on the measures taken to insure customer satisfaction, the awards received for products or services, the employees’ satisfaction, etc.

Starting from the desideratum of evaluating the real value of a company, Burgman and Roos (2007) suggested a simple reporting model, schematized in the figure below:

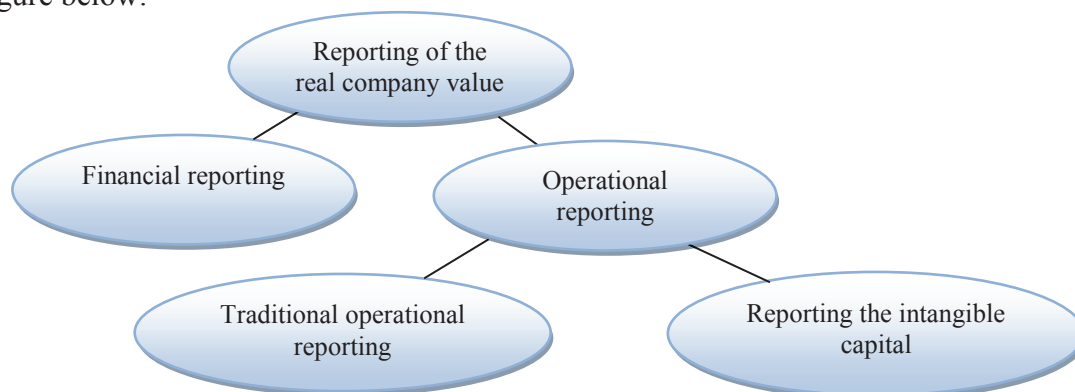


Figure 1. *The reporting model of a company's value*

Source: Burgman R., Roos G., (2007), “The importance of intellectual capital reporting: evidence and implications”, *Journal of Intellectual Capital*, Vol. 8, No. 1, p.29.

According to the model suggested by Burgman and Roos, the real value of a company can be reported through two sets of reports: the financial statements and a special report composed, in its turn, from a report on the company's operations and a report of the intangible capital. The report on the company's operations does not have a predefined format, but it must include information on the main factors that determine company performance, the changes occurred in the activity field of the company, the way in which it responded to the changes, the investment policy, the funding sources, the management risks, the resources, and the advantages not included in the financial statements.

The accounting terminology does not state that the goodwill is the only unidentifiable intangible asset. For example, it is possible for a company to encourage experienced managers to share useful information with the young employees. If we assume that this practice lead to lowering the design costs, then we can state that the company is more profitable than its competitors. In case that this company is bought, its organizational culture (internally generated unidentified intangible asset) would be implicitly included in the goodwill (Cohen, 2005, p.79).

Purpose and Methodology

In a study performed on 135 company acquisitions in the pharmaceutical field in Europe and North America, Boeckstein (2009) proves that the average value of an absorbing company increases after acquiring another company approximately 6 times, as a result of the increase of the value of its intangible assets (including the goodwill), which overlay, on the most part, on the value of intellectual capital. This way, Boeckstein launches the hypothesis that the financial statements of absorbing companies reflect, to a great extent, the value of the intellectual capital of the purchased company.

Starting from Boeckstein's hypothesis, we aimed to study the financial statements of the companies that acquired Romanian companies over the last years, with the purpose of identifying the goodwill they acknowledge after taking over autochthonous businesses.

Our approach proved to be Sisyphean work for at least three reasons:

1. The lack of transparency of the privatization processes in Romanian state companies.
2. Many foreign companies initially included in the study do not preserve on their official pages archives that would allow us to analyze their financial statements from the 90's.
3. The lack of information regarding a history of the privatizations on the page of the National Authority for Capitalizing upon the State Assets (AVAS).

Based on the annual activity reports of AVAS for the period 2004-2011, we followed the evolution of the number of privatizations in Romania, for the period 1992-2011.

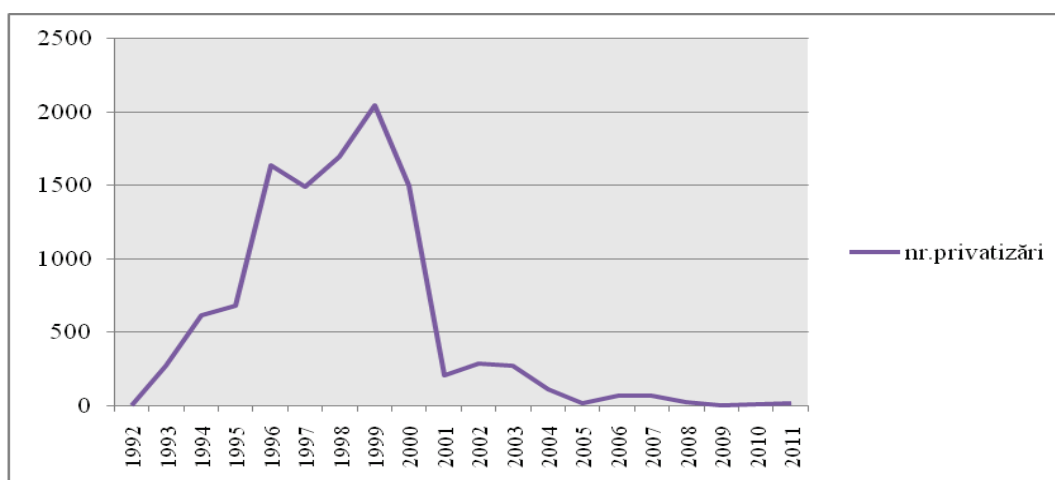


Figure 2. *Evolution of the number of privatizations in Romania, for the period 1992-2011*

Source: *projection of the authors based on the AVAS reports for the period 2004-2011.*

A climax of the privatization process can be noticed in the years 1998-1999, while under 20 privatization contracts have been signed during the last 3 years.

For the proposed approach, we identified 33 Romanian companies that have been privatized, of which 10 were acquired before 2000. The starting point in selecting the companies subject to the analysis was a top of privatizations, according to the criterion of the price paid by the acquiring company, published in August 2012 on the web site www.bursa.ro.

Table 1. *Top privatizations according to the price criterion*

No.	Transaction	Year
1	Bcr - Erste Bank	2006
2	Romtelecom - Oterom	1998
3	Romcim – Lafarge	1997
4	Brd – Societe Generale	1999
5	Rompetrol Rafinare – The Rompetrol Group	2000
6	Automobile Craiova - Ford	2007
7	Automobile Dacia- Renault	1999-2001
8	Casial Hunedoara- Heidelberg Cement	1997
9	Rulmenții Ploiești- The Timken Company	1997
10	Oțelinox Tg- Samsung	1997

Source: http://www.bursa.ro/ce-am-castigat-din-privatizari-177260&s=piata_de_capital&articol=177260.html

We have also taken into consideration the ranking done by Ziarul Financiar, following a study in which 100 managers and businessmen participated, concerning the most important privatizations for the period 2000-2005, from the point of view of the impact on national economy. Therefore, the first 10 transactions with an impact on economy are:

Table 2. *Top privatizations with an impact on national economy*

No.	Transaction	No. of votes
1	OMV- Petrom	50
2	Mittal-Sidex	44
3	Vodafone-Connex	17

4	Privatizare Electrica	16
5	Raiffeisen-Banca Agricolă	15
6	Rompetrol-Petromidia	11
7	Privatizare Distrigaz Nord Și Sud	9
8	Orange-Mobilrom	8
9	UPC-Astral	8
10	OTE-Romtelecom	7

Source: *Yearbook of Ziarul Financiar*, november 2005.

<http://www.businessmagazin.ro/cover-story/top-tranzactii-2000-2005-1047484>

As a result, we analyzed the financial statements of the companies that bought the majority packages for the following Romanian companies:

Table 3. *Analyzed companies*

No.	Acquired company/ bank	Purchasing company	Year/years transaction	Available data
<i>Banks</i>				
1	BCR	Erste Bank	2006	Yes
2	Bancpost	Eurobank EFG	2002	Yes
3	Banca Agricolă	Raiffeisen Zentralbank	2001	No
4	BRD	Societe Generale	1999	Yes
5	Banca Țiriac	Bank Austria Creditanstalt (BA-CA)-HVB	2005	No
<i>Telecommunications</i>				
6	Romtelecom	Hellenic Telecommunications Organization (OTE SA) through her subsidiary OTE International Investments Ltd. (Oterom) Cyprus	1998	No
7	MobilRom-Dialog	Orange	2001	No
8	Mobifon	Vodafone	2005	Yes
9	Telemobil (Zapp)	Ote through Cosmote Mobile Telecommunications through Cosmoholding Romania	2009	Yes
10	Cosmote România/Cosmorom	Ote(Cosmote Mobile Telecommunications)	2005	Yes
<i>Industry</i>				
11	Dacia	Renault	1999-2001	Yes
12	Automobile Craiova	Ford	2007	No
13	RompetrolRafinare(Petromidia)	The Rompetrol Group	2000	No
14	Rom Oil	The Rompetrol Group	2002	Yes
15	Petrotel Lukoil	Lukoil Europe	1998	No
16	Romcin	Lafarge	1997	No
17	Casial Deva	Henkelberg Cement	1997 și 2000	Yes
18	Moldocim Bicz	Henkelberg Cement	1998	Yes
19	Rulmenți Ploiești	The Timken Company	1997	No
20	Oțelinox TG	Samsung Deutschland	1997	No

		Gmbh		
21	Sidex Galați	Mittal Steel/Lnm Holdings Nv	2001	No
22	Rafo	Imperial Oil and Canyon Servicos LDA. From 2004, Balkan Petroleum	2001	No
23	Electroputere	AL-ARRAB	2007	No
24	Alro	Marco Int.	2002	No
		Vimetco NV	2007	Yes
25	Roman BV	Pesaka Astana/Pro Roman	2003	No
26	C.S. Reșița	Sinara Handel	2004	Yes
27	Chimcomplex	SCR Group	2003	No
28	Mechel TG	Mechel	2002	No
29	Industria Sârmei Câmpia Turzii	Mechel	2003	No
30	Siderurgia Hunedoara	Mittal Steel Holdings Nv (Lnm Holdings Nv)	2003	No
31	Famos Suceava	Top Genko Bucharest, GENKO Group	2007	No
32	Distrigaz Nord	E.On Ruhrgas	2004-2005	No
33	Distrigaz Sud	Gaz de France	2004	No
Total transactions with available data				12

We structured the privatization processes into three groups, referring to the banking system, to telecommunications, and to industry. As we can notice from the table above, we managed to identify the necessary data for only 36.36% of the transactions initially considered.

Results and Discussions

According to a report published by the Ernst & Young audit company (*M&A Barometer Report, Romania H1 2012*), in the first semester of 2012, only in 39% of the acquisition contracts of Romanian companies to foreign investors was the transaction value published, this reporting ratio being similar to that recorded for 2011.

The same limitation influences the results of our study: out of 33 privatization processes, only in 12 cases did we manage to find the information referring to the value of the transaction and its reflection in the accounting of the foreign company. Of the 12 analyzed transactions, in 3 situations the value of the goodwill was equal to 0: this is the case of the Hendelberg Cement group, which acquired Casial Deva and Moldocim Bicz and, respectively, of the company Sinara Handel, which acquired the Iron and Steel Complex of Reșița. It is important to notice that Erste Bank acknowledged, after acquiring the Romanian Commercial Bank, other intangible assets as customer relations, with a value of 693.1 million Euros, and the brand, with a value of 359.7 million Euros.

Table 4. *Results obtained*

No.	Acquired company/ bank	Purchasing company Percentage	Transaction value	Goodwill	Analyzed year
<i>Banks</i>					
1	BCR	Erste Bank - 61.9%	3.75 bil. euro	2,729.9 mil.	2007

No.	Acquired company/ bank	Purchasing company Percentage	Transaction value	Goodwill	Analyzed year
				euro	
2	Bancpost	Eurobank EFG-17% (up to 36.25%)	20.074 thousands euro	2,304 thousands euro	2002
3	BRD	Societe Generale - 51%	200.3 mil. dollars	50 mil. euro	1999
<i>Telecommunications</i>					
4	Mobifon	Vodafone - 79% (up to 99.1%)	2.5 bil. dollars (Wall Street estimation)	Estimation: max 1,367 mil. euro	2006 and 2007
5	Telemobil (Zapp)	Ote through Cosmote Mobile Telecommunications through Cosmoholding Romania Ltd -100%	67,041 thousands Euro	58,668 thousands euro	2010
6	Cosmote Romania/Cosmorom	Ote through Cosmote Mobile Telecommunications – 70%	121,834 thousands euro	Cosmote did not apply IFRS 3 (common control with OTE).	2005
<i>Industry</i>					
7	Dacia	Renault – 92.70%.	50 mil. dollars	70 mil. euro	2001
8	Rom Oil	The Rompetrol Group – 100%.	48,333, 487 dollars	46,483,142 dollars	2003
9	Casial Deva	Hendelberg Cement - 86.2%.	73 mil. euro	0	2000 and 2001
10	Moldocim Bicz	Hendelberg Cement – 84.8%.	63 mil. euro	0	2000
11	Alro	Vimetco NV – 0.22%.	7,474 dollars	6,345 dollars	2007
12	C.S. Reșița	Sinara Handel – 99.45%	652 thousand dollars (of which share price =1 euro)	0	2004

Conclusions

The limitations related to access to information resulted, mainly, from the passing of a significant number of years since the date of the transactions, do not allow us to formulate definite conclusions regarding the correspondence between the goodwill recorded in the accounting of the acquiring company and the value of the intangible capital of the acquired company. Nevertheless, we cannot ignore the significant amounts representing the goodwill corresponding to the acquired Romanian businesses, accounted in the case of 8 transactions of the 12.

Through this approach, we wished to draw attention on the unknown value of some companies, a value that becomes visible, at least partially, on the occasion of company mergers.

Without a doubt, the issue of the real value of a company remains open.

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