

Intangible Assets and Goodwill: Growth, Recognition and Alpha?



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The debate over the importance of intangible assets continues, in academia and in the market¹. Parts of the investment community dispute the inclusion of intangible assets in a company's asset base, claiming that the definition of intangibles is too restrictive or perhaps not restrictive enough. Other parts claim that valuation of intangible assets for accounting purposes is too subjective. A final group acknowledges that intangible assets are important, that defining and including them in company asset valuations is important, but that conservatism is better than the alternative. We at RQI are in this third camp.

Further to this, no-one really disputes the difficulties associated with accounting for and valuing goodwill, but almost everyone agrees that it exists and is important. Our main aim here is to better understand goodwill in the context of intangible assets, so we want to:

- Outline the idea of goodwill in the context of intangible assets

- Look at its size, evolution and importance

- Discuss excess build-up of goodwill and why it is probably a negative signal

An important note: in RQI Value strategies, we use accounting metrics to calculate the four factors in our Core portfolio: cash flows, dividends, adjusted sales (gross profit) and adjusted book value. Book value is simply the difference between total assets and total liabilities, which includes only the intangible assets that the firm chooses or is required to report. So this final element of Core – adjusted book value – is reported book value with two sets of further intangible assets added back; Research and Development (R&D) (as cumulative R&D expenditure over the preceding 5 years) and brand value. (We choose to measure brand value conservatively as cumulative sales and marketing expenses, also over the preceding 5 years. Different methods and proxies exist but in general they are more subjective in nature.) Of course, reported goodwill is already in total book value so no further adjustment is made for it.

We also note that excessive build-up of reported goodwill can be a sign of an overly aggressive acquisition strategy, which on average leads to write downs and future underperformance. So it is as an alpha source, rather than a core measure, that we use goodwill.

¹ See Lev, B. (2018) "Intangibles" NYU Working paper (2018) or Corrado C. and C. Hulten (2010) "How do you measure technological revolution?", American Economic Review, 100 (2) or <https://www.mckinsey.com/capabilities/growth-marketing-and-sales/our-insights/getting-tangible-about-intangibles-the-future-of-growth-and-productivity>

What is goodwill? What are intangibles assets?

In its broadest definition, goodwill is friendliness, helpfulness or cooperative feelings towards others². As individuals we can earn goodwill through charitable actions. That goodwill can be easily destroyed through poor or ill-considered actions, or simply through outside influences – and the same applies in business. Goodwill is created and grows through internal and external corporate activity, as discussed below. It can also become “impaired” through inaction, poor decision making and market conditions.

To understand the nature of goodwill in a business sense, and why it is important, we first need to step back and think about the broader category of intangible assets. Simply put, these are assets whose value can be measured reliably and offer a future economic benefit³, so they appear on a company’s balance sheet but do not represent physical tangible assets. Tangible assets are items like property, plant and equipment (PPE) and investment properties owned by the company. Intangibles assets are assets that have an accounting value but are not physical.

More specifically, an intangible asset “...is identifiable when it is separable, or when it arises from contractual or other legal rights. Separable assets can be sold, transferred, licensed, etc.”⁴

For example, this might include:

- brand equity acquired through sales and marketing expense
- intellectual property (IP) as patents or trademarks acquired through research and development (R&D) expense
- computer software
- copyrights
- import quotas
- licensing
- customer lists
- and finally, goodwill

The growth in intangible assets has been extraordinarily strong and steady over the last 20 years or so. Figure 1 shows this growth for all stocks in the MSCI World index and for different size segments of the index.⁵ The chart shows the average Asset Ratio, which is Reported Intangible Assets divided by Reported Total Assets, averaged over rolling 12 month periods (average is equally weighted not market cap weighted).

One final note here: companies have some flexibility to report goodwill and other intangibles (for example, under US GAAP) so there can be significant variation in the measurement of goodwill even between close peers (e.g., Apple and Microsoft, see later). Coupled with the conservative nature of intangibles reporting, this can reduce the comparability and meaning of a signal based on goodwill, so we need to be cautious in applying such a signal.

² See for example <https://www.merriam-webster.com/dictionary/goodwill>

³ <https://www.ifrs.org/issued-standards/list-of-standards/ias-38-intangible-assets/>

⁴ Ibid.

⁵ The measurement of the true size of intangible assets is quite controversial. Accounting standards explicitly capture intangibles of the types listed here. However, other research suggests that the scope of intangibles is much larger than this, and of a much greater size. See for example Corrado et al (2022) and earlier work by Corrado and other authors. As this is an area of some contention (both in scope and size) we restrict ourselves to the reported numbers, which are almost certainly conservative.

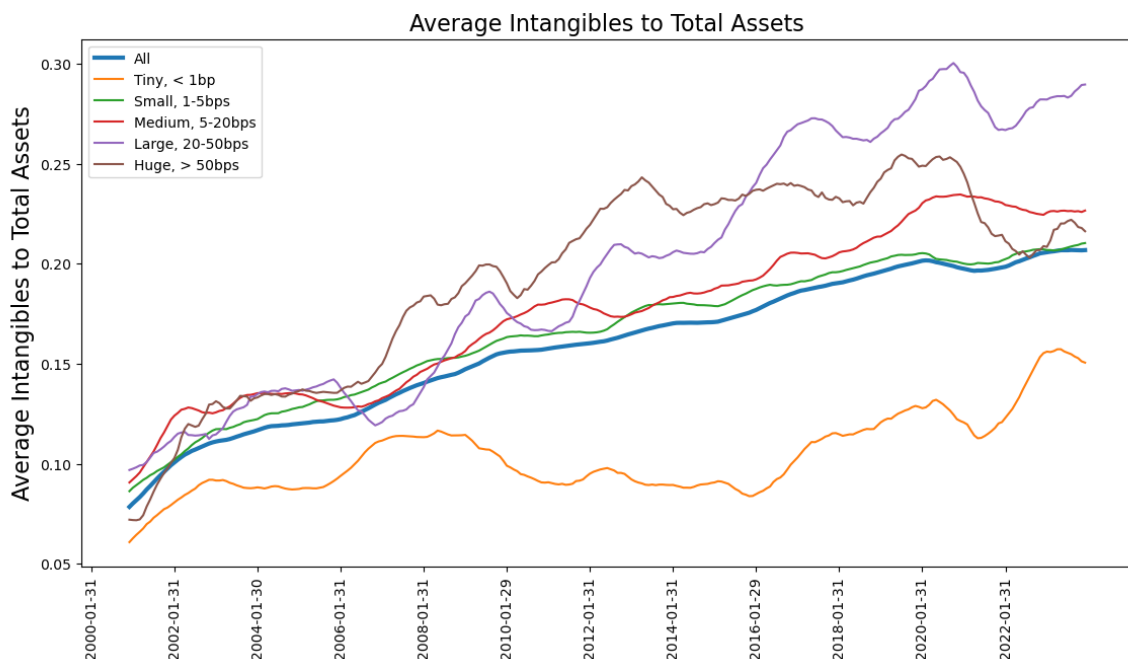


Figure 1: Rolling 12 month average Asset Ratio (which is Reported Intangible Assets divided by Reported Total Assets) across stocks in MSCI World

Source: RQI Investors, 2024

The data is annual, and each year's reported value is carried forward throughout the year until replaced by the next (annual) reported value. Then a rolling 12 month average is used to smooth out variations due to different reporting dates. Note that this reflects the formal accounting valuation of intangibles as required by the various accounting standard bodies (IASB and IFRS outside the US, FASB and GAAP in the US).

This growth reflects two major trends:

The changing nature of the economy away from physical production assets towards a knowledge economy.

The increasing recognition of the value in intangibles by accounting regulatory bodies, industry bodies, companies and the academic community.

Variation of Intangible Assets by Firm Factors

Before moving to look at goodwill itself, below we examine whether intangible assets (as a percentage of total assets) vary by firm quality (measured as ROE, which is net income divided by shareholders' equity⁶), value (as measured by trailing earnings yield, net income divided by current price) and risk (as measured by beta⁷, estimated using weekly data over the last 52 weeks). Figure 2 Panels A to C show the results. We group all firms in the MSCI World universe at each date into one of five groups based on ROE, EY and beta. Within each group we calculate the average intangibles to total assets ratio - note again these are 12 month rolling equally weighted averages within each grouping.

Clearly, from Panel A, higher ROE firms tend to have higher intangibles as a % of assets, although this effect has only really been evident following the GFC, from around 2010 onwards. In the lower interest rate environment of the decade following GFC, ROE-additive acquisitions appear to have been in vogue.

Also of interest is the level of intangibles for the lowest ROE firms, which hovers around the global average. We know (from elsewhere) that quality as a factor has performed well during this decade, which runs a little contrary to the result that it seems to correlate with higher intangibles (and our prior is that – for example - higher goodwill is worse, all else equal). However, quality as a signal (with ROE our example here) tends to work well not because the best companies outperform, but because the worst companies consistently underperform. These companies (ROE < 0) still have a high intangibles component of assets, which might support this idea.⁸

Panel B shows that cheaper firms tend to have lower intangibles, and expensive firms have greater intangibles, although this is by no means uniform and consistent. We can conclusively say that cheaper firms have low intangibles to assets and have not seen the upward trend observed in more expensive names. This plays in some way to the idea that expensive companies are more likely to acquire other firms (often using their expensive scrip) and so build up intangibles via goodwill - but that conclusion is far from universal.

The sharp rise in intangibles to assets for cheap firms in 2008 coincides with the sharp fall in asset values as a result of the GFC. We do not see this for the more expensive names.

Finally, in Panel C, there appears to be little consistent relationship between beta and intangibles as a percentage of total assets, other than high risk (or high beta) names having lower intangibles. Often, we associate lower beta with higher quality, but here we do not really see this.

⁶ Shareholders' equity is total assets less total liabilities

⁷ Alternative measures of risk - like return volatility – have similar results.

⁸ One important point about these charts is that they are not sector neutral. So (for example) if there is substantial move in ROE between sectors, it could explain some of the results in this chart. However, high ROE stocks seem to have persistently higher intangibles-to-assets than lower ROE for most of the last decade and even longer, which would not be the case if sector rotation in ROE was a large driver.

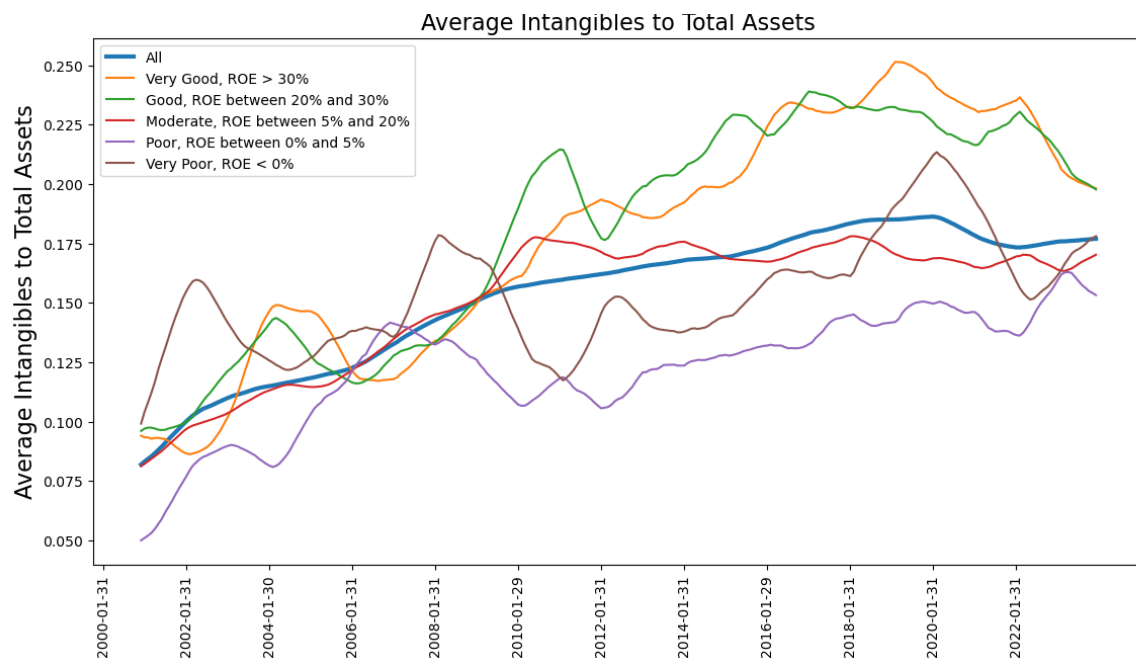


Figure 2 Panel A: Intangibles to Total Assets grouped by ROE

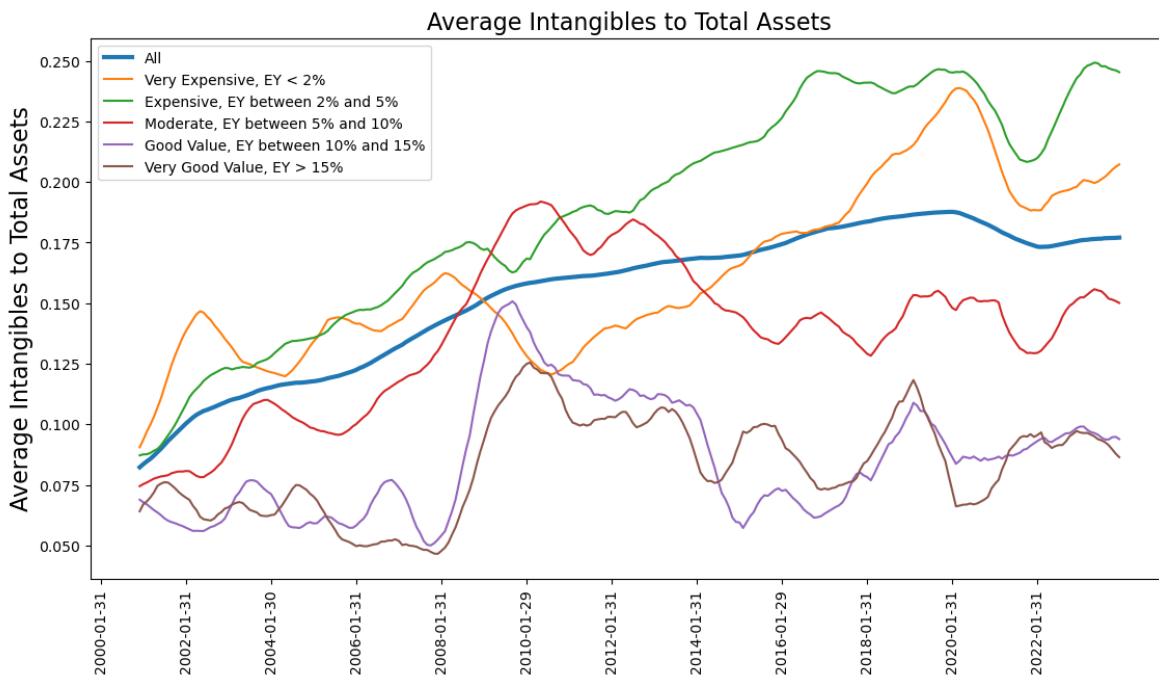


Figure 2 Panel B: Intangibles to Assets grouped by EY

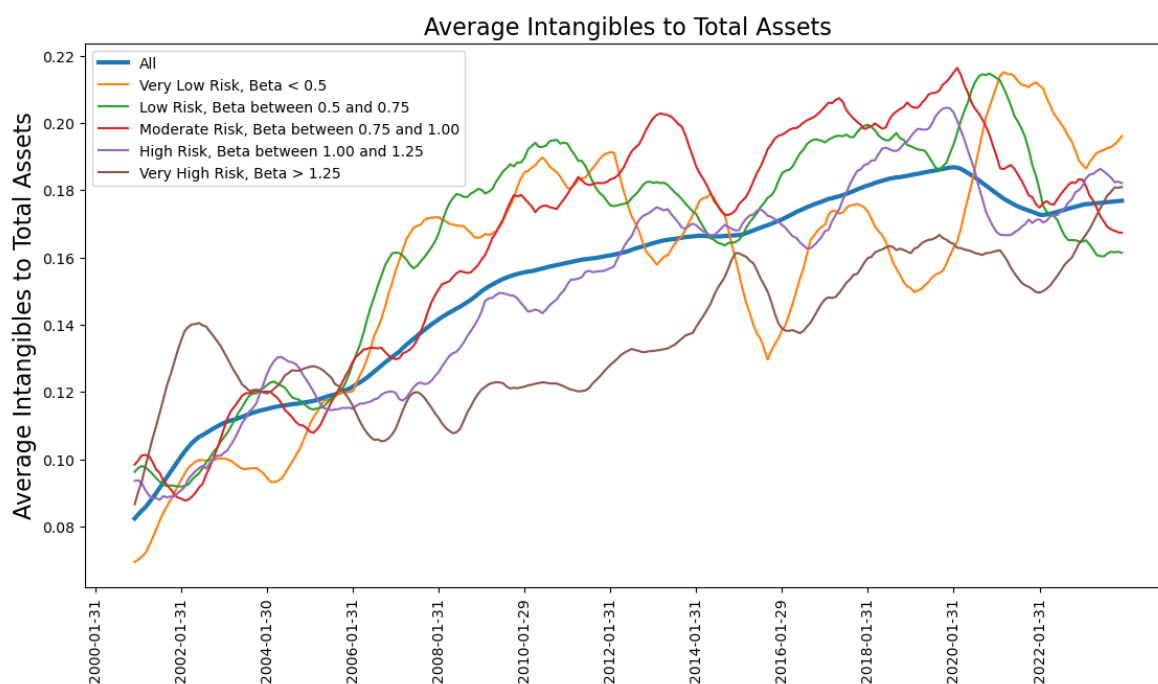


Figure 2 Panel C: Intangibles to Assets grouped by Beta

Figure 2: Intangibles to Assets grouped by underlying firm factors

Source: RQI Investors, 2024

Size, evolution and importance of goodwill⁹

Growth and Concentration

Goodwill has grown steadily over time as a proportion of total assets reported on balance sheets. Figure 3 shows this for the MSCI World universe, this time using a 36 month rolling (equally weighted) average of the ratio of goodwill to total assets. Goodwill had grown from an average of around 7% of total assets in 2003 to over 12% in by the end of 2023. Comparing with Figure 1, we can see that goodwill constitutes more than 50% of intangible assets through the sample period.^{10 11}

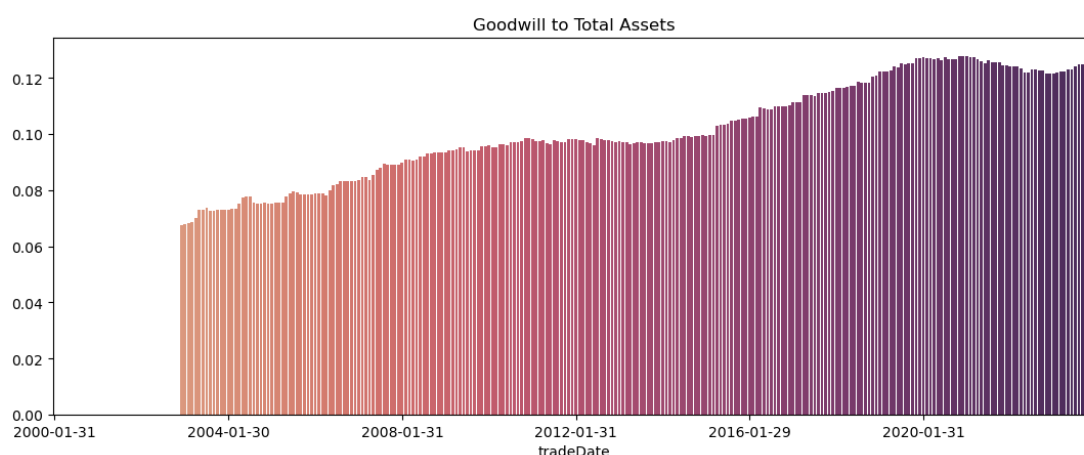


Figure 3: Growth in Goodwill over time.

(Goodwill as a % of Total Assets. MSCI WLD, 36 month rolling average)

Source: RQI Investors, 2024

We can also ask whether this growth of goodwill is concentrated in more or fewer companies. To do this, we calculate the Herfindahl index¹² at each date in the sample, and then show the 12 month rolling average in Figure 4. Note we use the reported value of goodwill itself, not scaled by total assets.

Concentration of goodwill was high at the time of the “tech wreck” of 2000-2001, and fell away sharply following that time. Although it is difficult to interpret the value this index represents, goodwill concentration was roughly 30% lower in 2006 than it was in 2002, and it stayed more or less at this level until 2015, when it started to increase. It has continued to increase steadily from that time, and is now at a higher level than we saw before the tech wreck.

⁹ The Appendix contains a description on how goodwill is generated.

¹⁰ We have retained the use of equally weighted average here to demonstrate the growth across all market cap sizes. If we were to use market cap weighted, this average would be larger, as large cap firms have a larger proportion of goodwill in their total assets. Note also that we use local currency values here. We chose 36 months to smooth out some of the short term variations and better show the long term trend.

¹¹ Note that data coverage in this universe is good, so will not be a contributor to this growth.

¹² Also known as the Herfindahl-Hirschman (HH) index, this calculates concentration as the sum of the squared proportions for each firm of the sum of all goodwill. So if there are three firms in the sample, with proportions of total goodwill of 25%, 25% and 50%, the HH index would be $0.25^2 + 0.25^2 + 0.5^2 = 0.375$. But if the proportions are 10%, 10% and 80% (that is, more concentrated) the HH index moves to 0.66. See https://en.wikipedia.org/wiki/Herfindahl%E2%80%93Hirschman_index for more details.

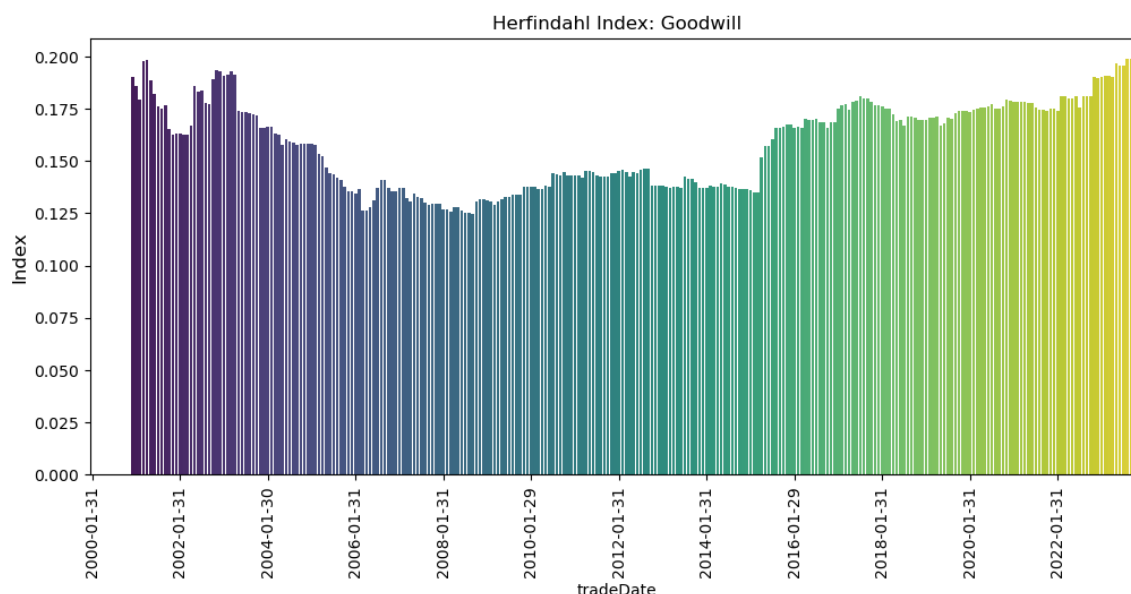


Figure 4: Concentration of Goodwill - Herfindahl Index

Source: RQI Investors, 2024

Where (region, sector)?

In developed markets, North America, Europe and UK dominate goodwill. Developed Asia and Japan have a much smaller component of total assets that is goodwill. Figure 5 shows the changes of goodwill to total assets for some of these regions:

North America, growing from around 10% to nearly 17%

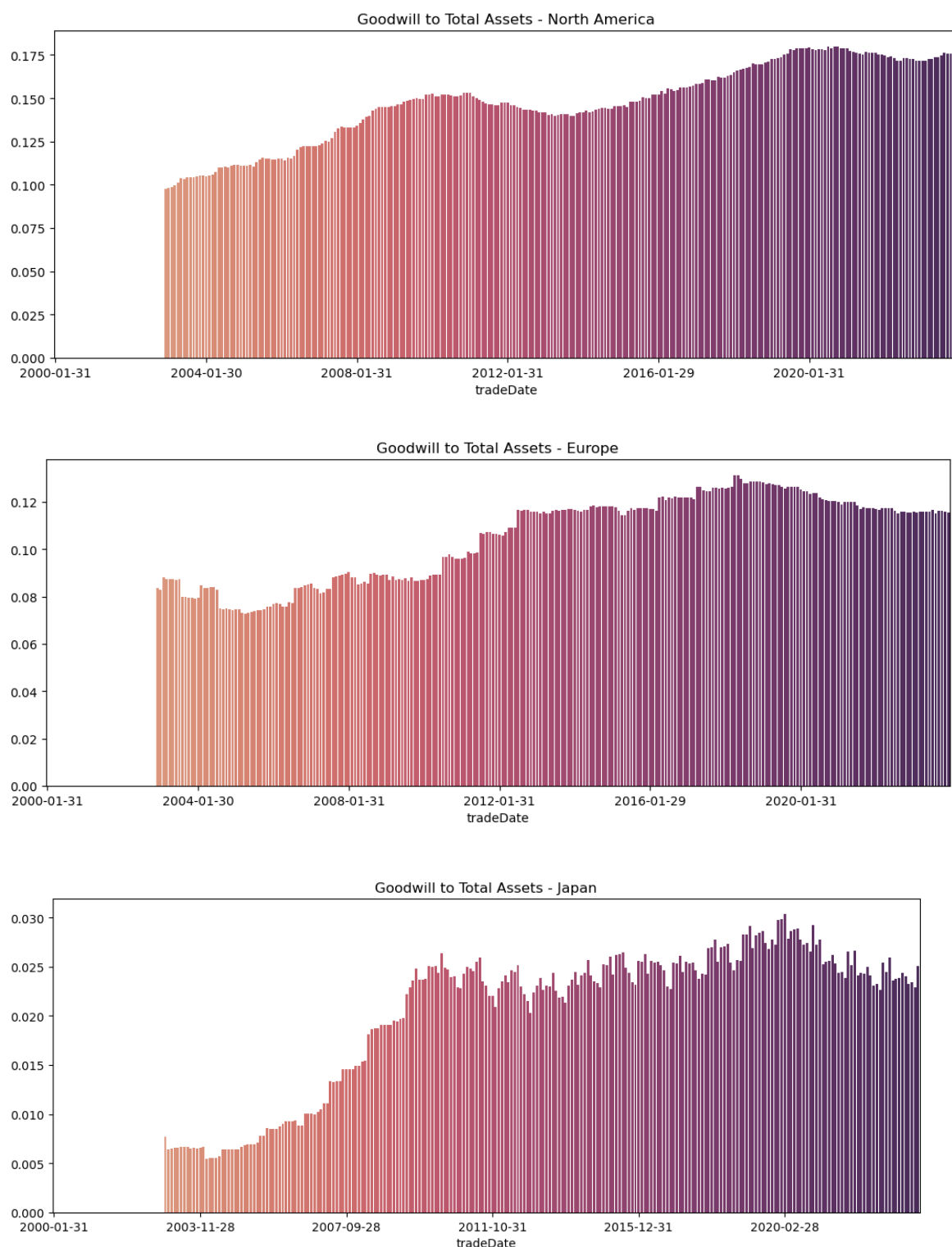
Europe, growing from 8% to nearly 12% but then reversing slightly more recently (UK is similar)

Japan growing from a very low base to around 2.5% in 2009 where it has stayed since then.¹³

Figure 6 looks a little more deeply into this. The Information Technology sector is where the bulk of the growth has been and is shown here – other sectors not shown here vary considerably (Health Care and Consumer Discretionary rise sharply then fall, Energy and Materials are lower but are subject to write-downs with slowing economic cycles). Still other sectors – Utilities, Real Estate – show almost no goodwill at all.

Given the growth of the IT sector in North America, this chart is also included in Figure 6 and shows exactly the same pattern – indicating that the recent growth and increased concentration of goodwill is largely due to this part of the market. Note that this would not necessarily have been the case in the past.

¹³ Developed Asia – not shown here – also has a low average value but is more volatile.



*Figure 5: Growth in Goodwill over time for various regions.
(Goodwill as a % of Total Assets. 36 month rolling average)*

Source: RQI Investors, 2024

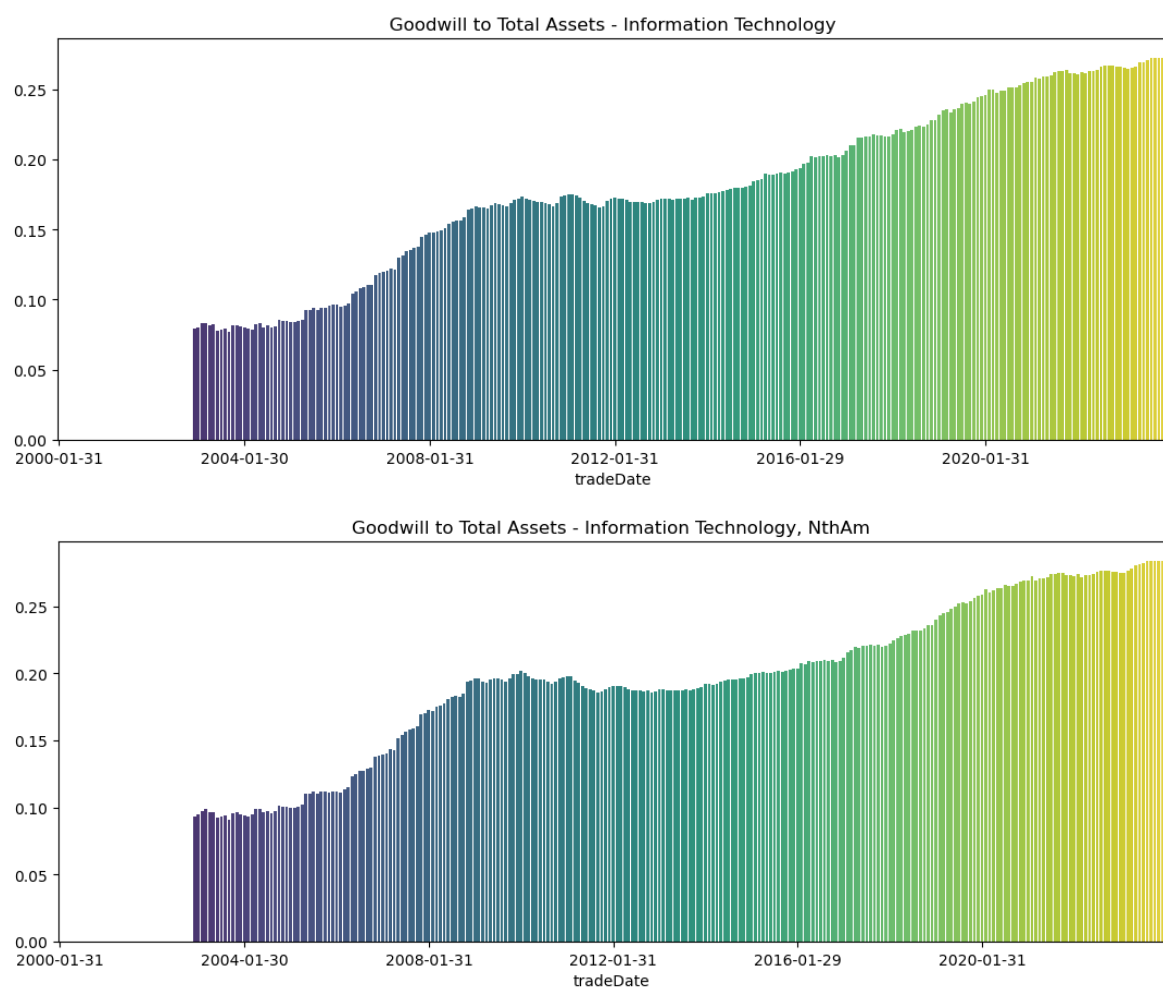


Figure 6: Growth in Goodwill over time for the Information Technology (IT) sector, and more specifically for IT in North America

(Goodwill as a % of Total Assets. 36 month rolling average)

Source: RQI Investors, 2024

Finally, to give a little context at a stock level, we have plotted in Figure 7 the ratio of goodwill to total assets for four well known stocks, to indicate the variation at a stock level and how different company policies drive these. What emerges from this is the extent of the choices that companies have to report intangibles under GAAP compared to IFRS.

- Apple has had little reported goodwill as a proportion of total assets throughout its life, peaking at only 2% in 2014 and falling to zero in 2018, where it has remained ever since. In fact, Apple reports no intangible assets *at all*. Goodwill from acquisitions does not appear – Apple’s acquisitions are numerous¹⁴ but do not include a recording of goodwill. This could be to avoid the risk of impairment.

However, this does not mean that Apple actually has no intangible assets or goodwill, only that it has no desire or regulatory requirement (under US GAAP) to present them. IP is clearly very large, and R&D is expensed rather than capitalised.

- Microsoft has a different approach to Apple. It now reports a total of USD148bn in intangibles (as at Dec 2023), of which USD118bn is goodwill. This means more than 15% of Microsoft’s reported total assets are goodwill alone. Goodwill largely arises from acquisitions¹⁵ and is tested for impairment annually.¹⁶ The large recent acquisition of Activision Blizzard (USD69bn) in 2022 of which USD51bn is reported as goodwill¹⁷. When Microsoft acquired LinkedIn in 2016 for USD26bn, it reported USD16.8bn of goodwill.¹⁸
- Meta had low goodwill as a percentage of total assets until 2014, when it acquired the messaging service WhatsApp for the huge amount of USD21.8bn (initially USD19.6bn, but the scrip component of the bid increased sharply following the announcement), of which USD15.3bn was recorded as goodwill.¹⁹ This goodwill has been tested for impairment every year since, as part of Meta’s internal policy on goodwill, but has seen no write-downs. The sharp fall in the goodwill to total assets ratio is due to the growth of total assets (from USD40bn in 2014 to USD230bn in 2023).²⁰ In fact, goodwill has increase slightly over this time.
- Tesla, the pioneer electric vehicle manufacturer, only shows tiny amounts of goodwill. While it does use M&A from time to time, none of the acquisitions are large and they generate very little goodwill as a percentage of total assets. Its intangible asset total is also very small. This of course does not mean that Tesla does not have very large intangible assets generated by its substantial IP. It simply does not choose to report these.

¹⁴ https://en.wikipedia.org/wiki/List_of_mergers_and_acquisitions_by_Apple

¹⁵ https://en.wikipedia.org/wiki/List_of_mergers_and_acquisitions_by_Microsoft

¹⁶ See for example <https://www.microsoft.com/investor/reports/ar23/index.html>

¹⁷ <https://www.microsoft.com/en-us/Investor/earnings/FY-2024-Q2/IRFinancialStatementsPopups?tag=us-gaap:GoodwillDisclosureTextBlock&title=Goodwill>

¹⁸ <https://www.microsoft.com/en-us/Investor/earnings/FY-2017-Q4/IRFinancialStatementsPopups?tag=us-gaap:GoodwillDisclosureTextBlock&title=Goodwill>

¹⁹ <https://www.sec.gov/Archives/edgar/data/1326801/000132680115000006/R9.htm>, <https://techmonitor.ai/technology/data/whatsapp-goodwill-is-worth-153bn-facebook-says-291014-4421026>

²⁰ <https://investor.fb.com/financials/>

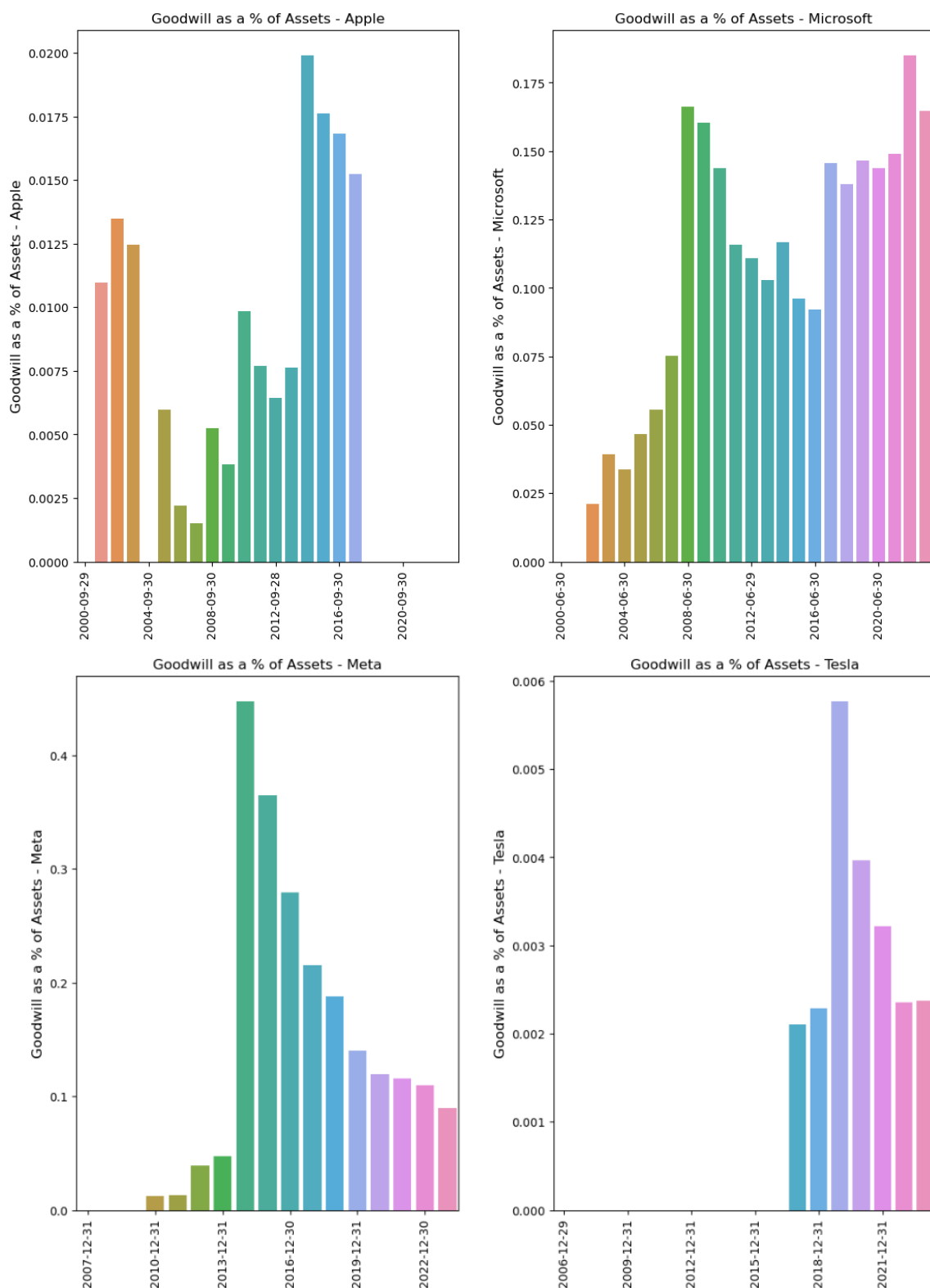


Figure 7: Goodwill to Assets for a sample of firms

Source: RQI Investors, 2024

Betting against excess goodwill

Why growth in goodwill is generally bad

We believe that goodwill is (on average) a negative signal for three reasons²¹:

- Excessive premiums paid for takeovers (also known as the winners curse) can create too much goodwill.
- Firms which are unable to generate organic growth may try to buy in intellectual property and brand value through acquisition.
- Higher goodwill is indicative of firms with management hubris and/or engaged in empire building behaviour.

It is better to look at *change* in goodwill since reported level of goodwill may have accumulated over many years, thus have little relevance to current valuations or at least be fully priced-in.

For demonstration purposes, we use the *three-year-change* in goodwill. The first year post-acquisition is a honeymoon period where the market is fairly forgiving due to challenges of integration and is also absorbing the complex accounting around the acquisition. In later years, the acquisition is old news and the market may be looking to how it has affected aggregate firm performance. We also divide by *enterprise value* (EV) to scale the size of the goodwill relative to the total firm value. This focuses on its economic significance and captures the source of capital used for acquisition. That is, by using EV rather than total assets or market capitalisation we are agnostic to firm structure and indeed how a large acquisition was funded (issuing new equity or debt).

Where to apply it?

A key issue to be aware of with the signal is that it is not homogenous across regions and sectors. If the mean signal is small and does not vary greatly over time, then the opportunity for stock selection with that region or sector is lower. From Figure 8 below, we can see that most variation in the signal comes from Europe and North America, and the average signal values are very small in Real Estate and Banks (the latter due to high EV values).

All this suggests is that we need to be careful in where we apply the signal. Our preference is always to apply an idea everywhere if possible, but if the opportunity set is too limited, data quality is uncertain and/or there is no demonstrated excess return, then we may not apply the signal to certain regions or sectors.

²¹ We say “on average” here because there are clearly many cases where growth in goodwill through acquisition will result in positive outcomes. For example, a coal mining company might acquire a clean energy company, increasing reported goodwill in the process, to improve its environmental exposure and participate in the economy wide transition to a lower carbon economy.

Data on 2022-09-30

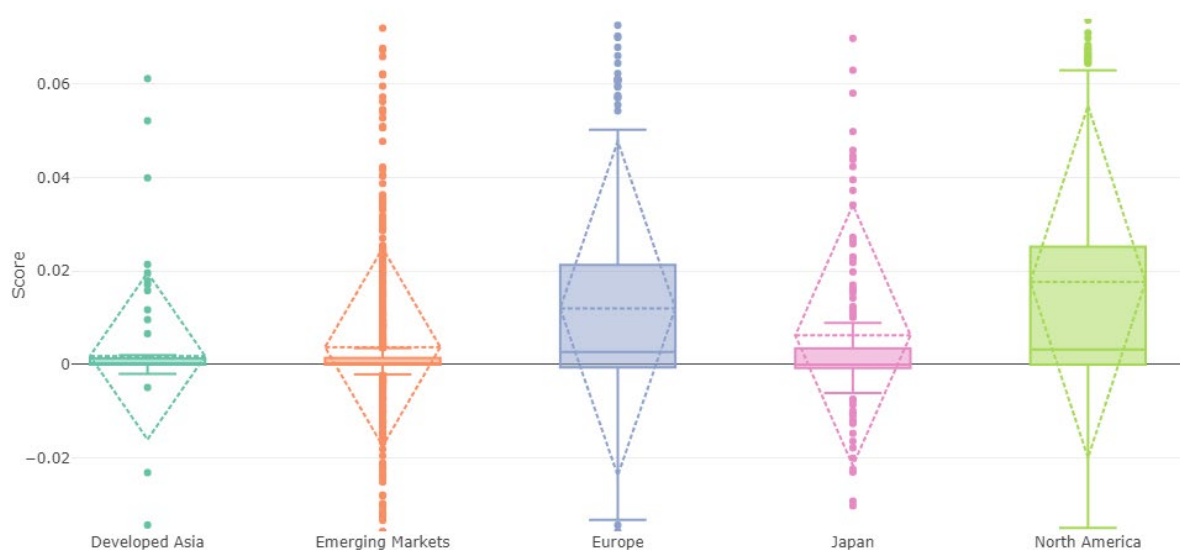


Figure 8 Panel A: Spread of signal score by region

Data on 2022-09-30

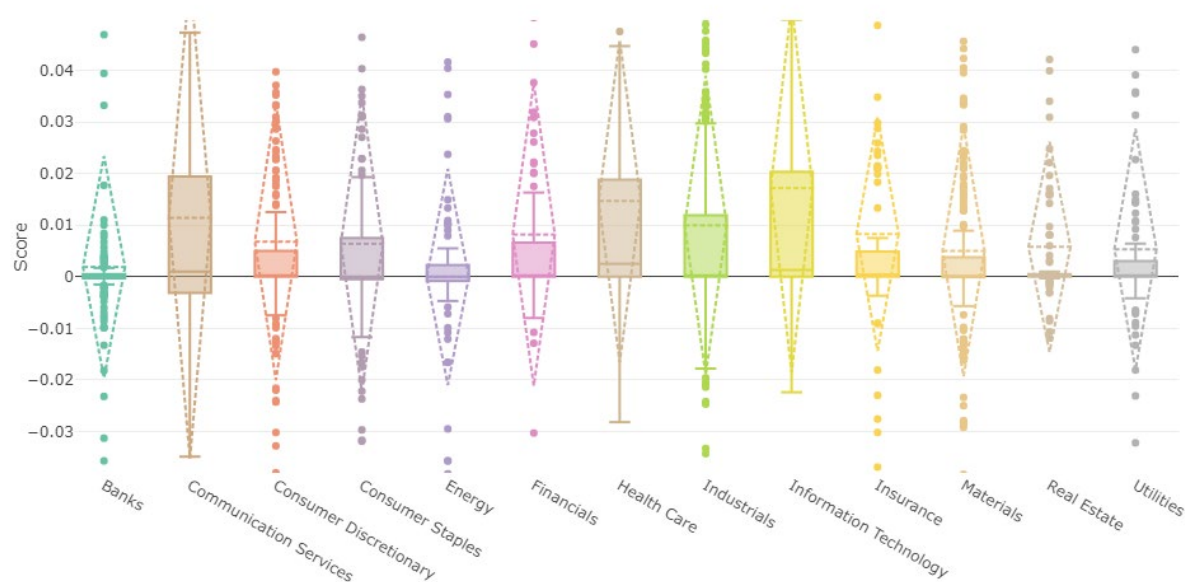


Figure 8 Panel B: Spread of signal score by sector

Figure 8: Spread of signal by region (Panel A) and sector (Panel B)

Source: RQI Investors, 2024

Some signal discussion and empirical results

The signal performs well if it is sector-neutralised – that is, we only use it to select between stocks within sectors rather than between sectors. Figure 9 shows these results for MSCI World (Panel A) and for ASX200 (Panel B). Each shows a steady cumulative alpha over time, interrupted by small selloffs in 2014-2015 for the MSCI World and 2004-2005 for the ASX200.

At the same time, the signal is not highly correlated with other signals or signals composites. Table 1 shows correlations for 3 year change in goodwill (GW) divided by current enterprise value (EV) (the signal) against a range of our existing factors. (Note that the goodwill signals are reversed – that is, a firm with higher GW or 3 year change in GW have lower signals. This follows the intuition that higher goodwill is a negative signal.)

Further, purely for comparison, we have included correlations with the same signal but now divided by total assets (TA), and the current level (rather than 3 year change) of goodwill dividend by EV or TA. Panel A shows MSCI World, Panel B shows ASX200. Both Panels shows the average cross sectional rank correlations with the goodwill signal inverted (as the signal would be applied in practice). Highest correlations for MSCI World are small, and a little higher for the ASX200 - highest correlations are with EY, quality and momentum, and the final alpha. None are sufficiently high to be concerning.²²

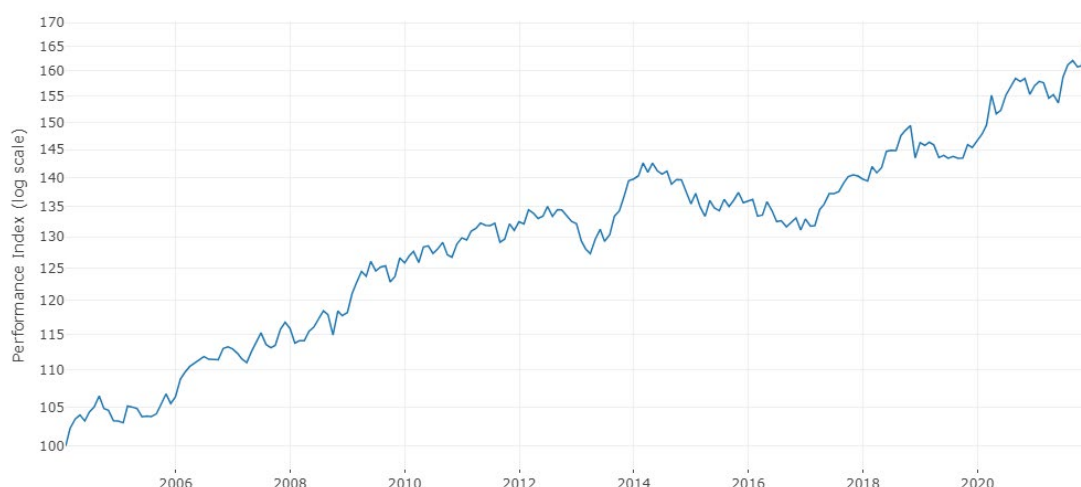


Figure 9 Panel A: Cumulative return of sector neutral signal in MSCI WLD

²² Testing is currently underway to assess whether this signal will be used in any of our strategies.



Figure 9 Panel B: Cumulative return of sector neutral signal in ASX200

Figure 9: Cumulative returns of 3 year change in goodwill dividend by enterprise value

Source: RQI Investors, 2024

<i>Factor</i>	<i>GW/TA</i>	<i>GW/EV</i>	<i>(3 yr change in GW)/TA</i>	<i>(3 yr change in GW)/EV</i>
<i>ROE</i>	-0.07	0.09	-0.09	-0.03
<i>BETA (inverted)</i>	-0.02	0.01	-0.04	-0.03
<i>EY</i>	0.08	0.03	0.03	-0.01
<i>Momentum</i>	0.02	0.04	0.03	0.03
<i>Quality</i>	0	0.14	0.07	0.12
<i>Relative Value</i>	-0.03	-0.19	0.08	0.01
<i>Sentiment</i>	0	0.01	0.01	0.02
<i>Reversal</i>	0	0	0	-0.01
<i>Existing alpha</i>	0.01	0.07	0.09	0.11

Table 1 Panel A: Correlation of goodwill signals (reversed) with known factors. MSCI WLD

<i>Factor</i>	<i>GW/TA</i>	<i>GW/EV</i>	<i>(3 yr change in GW)/TA</i>	<i>(3 yr change in GW)/EV</i>
<i>ROE</i>	0.03	0.2	-0.07	0.01
<i>BETA (inverted)</i>	0.01	0.04	0.01	0
<i>EY</i>	0.02	-0.02	0.01	-0.01
<i>Momentum</i>	0.03	0.06	0.01	0.03
<i>Quality</i>	-0.02	0.11	0.13	0.19
<i>Relative Value</i>	-0.12	-0.26	0.05	-0.01
<i>Sentiment</i>	0.01	0.05	0.01	0.03
<i>Reversal</i>	0	-0.01	-0.01	-0.01
<i>Existing alpha</i>	-0.01	0.06	0.1	0.14

Table 1 Panel B: Correlation of goodwill signals (reversed) with known factors. ASX200

Table 1: Correlation of goodwill signals (reversed) with signal composites.

Source: RQI Investors, 2024

Summary and Conclusions

Intangible assets come from many sources, some more concrete to define and measure, other more ephemeral and subjective. Examples of intangible assets include capitalised R&D appearing as IP, and brand value arising from sales and marketing expenses. RQI capitalises both of these to get a better picture of book value in our Core valuation model. Others, like goodwill, are harder to value. Note that reported goodwill appears in book value.

Intangibles form a large and growing component of total assets, and goodwill constitutes at least half of the recorded balance sheet value of intangibles. There is significant variation of intangibles across measure of quality and value, with a tilt towards higher quality and more expensive stocks, but we do not see this for risk (measured as beta).

It is generally accepted that the regulatory requirement to disclose intangibles is conservative compared to true valuation, and flexible enough to allow firms which clearly have large components of IP in their values (for example Apple and Tesla) to report little of this as goodwill. This means that much of the value of intangibles (and goodwill) may be under-reported. Concentration of goodwill in firms, measured using the Herfindahl index, is at the highest in 20 years.

Much of the growth in goodwill has been in the North American Information Technology sector, although it by no means uniform across stocks. For example, Apple and Microsoft have very different approaches to reporting intangibles and goodwill and their reported numbers show this.

Finally, we consider the prospect of using a firm's upward trend in goodwill as a proportion of its size to be a potential indicator of overpayment for assets M&A activity, and so might represent a negative signal. The variation in reporting requirements and choices makes this signal more dubious, but it seems to perform well (sector neutral) and is not highly correlated with other signals. Work still needs to be done to get comfort that a signal based on goodwill growth will be additive to our alpha model.

Appendix: How is goodwill generated?

Here we go into some detail on the generation of goodwill. Goodwill is not a “new” intangible asset on balance sheets like IP or R&D. It has been with us – on balance sheets – for a long time.²³ It represents now more or less the same as it always has – a quantitative measure of the difference between price that might be or has been paid for an asset (e.g., through expenses incurred or through purchase in M&A activity) and the fair market value of that asset. Note that the value of goodwill on a balance sheet is not related to the share price of the stock, only to the market value of the asset to which it is attributed.

To better understand this, we need to look into how goodwill is actually generated.

What is goodwill paying for? The three factors in the creation of a company's goodwill include its going concern value, excess business income, and the expectation of future economic benefits. There are two types - inherent and purchased:

Inherent: internally generated goodwill, arising over time through business activities (for example brand value or intellectual property). If measured and reported, these appear as intangible assets in the company's balance sheet. However, in many cases these are not explicitly measured and reported as intangibles in financial statements, but are simply implicit in the operating model of the business. Indeed firms with very high ROAs are often those with significant intangibles that are not capitalised on the balance sheet and thus not counted in the denominator of ROA.

Purchased: through M&A, when the purchase value is greater than the fair market value of tangible assets. Or:

$$GW = \text{Acquisition Price} - (\text{Fair Value of Assets} - \text{Fair value of Liabilities})$$

When an asset is purchased, the goodwill (which is the excess over the net fair value of assets) constitutes ownership of the legal right to conduct the business using those net assets.

Goodwill can be essentially thought of as “intangible property” that can't be separated from the business and does not exist away from the business. From a legal or tax perspective, this definition as “property” arises due to the need for a transactions tax (for example, stamp duty in Australia) to be calculated and applied, or as a way to crystallise the net fair value of assets.

Purchased goodwill is then the physical dollar “property” value assigned to such factors as brand value and intellectual property that are valuable in addition to the net value of the physical assets.

Since goodwill is intangible, it is subject to differences of opinion of its worth. Expectations of the value of a brand or for the intellectual property resident in a business can be different between buyers and sellers. Further, in a competitive bidding process for a firm, increases of bids by aspiring owners are not due to greater valuation of the net fair value of assets – rather they represent increased expectations of the value of the goodwill that the firm carries.

In addition to this, a competitive bidding process can lead to the payment of a “control premium”, or an amount paid over the bidder's original valuation to ensure ownership. Obviously, if successful, this extra amount increases the reported goodwill for the purchase. This can also be ascribed to management “hubris” (an ancient Greek term for pride or overconfidence) where overly confident, aggressive or perhaps even empire building

²³ For example: Dicksee, Lawrence R., Tillyard, Frank, “Goodwill and Its Treatment in Accounts”, Gee and Co., Printers and Publishers, Third Edition, 1906,

management can overpay for businesses, generating goodwill that overvalues the potential of the intangible assets in the firm they are acquiring.

So the potential for “overpaying” for intangibles is high, driven by this control premium/management hubris, which means that inflated values of goodwill on the acquiring firm’s balance sheet is also likely.

The question then has to be asked – does the market agree with this control premium or excess goodwill payment? Or does the market sell off firms which pay excess goodwill in the expectation that the anticipated delivery of value does not materialise? This question leads us to examine the key idea here – this overpayment does not pay off, on average, and the build-up of goodwill is a negative signal for future value.

One last point relates to retaining goodwill valuation. Goodwill does not record accounting depreciation in the same way as physical assets, but is kept on the balance sheet at the purchase price. For many years prior to 2001, goodwill was amortised (that is, slow reduction of goodwill). This was achieved by reducing its value by a small amount each year - writing it off as a loss to be entered into the income statement). In 2001 this amortisation was prohibited under GAAP and IFRS.²⁴

Instead, an annual “impairment test” is conducted to assess whether the intangible asset value remains reasonable. This is done in practice by assessing its value (for example, using net present value (NPV) techniques) when in combination with other net assets.²⁵

Goodwill can become “impaired” if it is thought to be overstated (that is, for the combined value of net assets with goodwill). In that case, a write-down of the carrying value of assets (specifically goodwill) is required, this write-down is registered as a loss and it appears in the annual income statement of the firm. Many profitable firms have been forced to recognise large losses in the annual income statements due to this requirement.

Some examples of large goodwill write-downs are:

In 2020, US public companies wrote down a total of USD143bn of goodwill, the most since 2008.²⁶ Among these was AT&T, which wrote down USD10.5bn in goodwill, due to two items. Technology changes in the form of digital media had reduced the value of its pay TV business. And the Latin American part of its DirecTV business (acquired in 2015), renamed Vrio Corp, was written down due to sale at a significant discount to its accounting value to AT&T.²⁷

In 2009, Conoco Philips wrote down USD39bn of goodwill from its asset base due to falling oil prices. That year the firm registered a loss of 31.5bn due to this writedown.²⁸

In early 2008, Royal Bank of Scotland wrote down GBP5.9bn which it had built up following a series of mergers and acquisitions (including ABN Amro and NatWest)²⁹ and was bailed out by the UK government in late 2008.³⁰

²⁴ Notable in this respect is SFAS 142 from FASB, which removed the annual amortization of goodwill starting December 2001.

²⁵ In 2014, FASB reversed this ruling for private companies only (as the cost of impairment testing was considered to be too onerous). They can now use straight line amortisation over a maximum of ten years, and an impairment test is only triggered in more drastic circumstances (e.g., when the entire firm’s value is below carrying value of goodwill).

²⁶ <https://www.wsj.com/articles/companies-wrote-down-goodwill-in-spades-last-year-as-the-pandemic-took-a-toll-11614780000>

²⁷ <https://investors.att.com/~media/Files/A/ATT-IR/financial-reports/annual-reports/2020/notes-to-consolidated-financial-statements-2020.pdf>

²⁸ <https://www.nytimes.com/2009/01/29/business/29conoco.html>

²⁹ <https://www.reuters.com/article/idUSL8509793/>

³⁰ <https://www.nytimes.com/2008/11/29/business/worldbusiness/29rbs.html>

Accounting for goodwill remains imperfect: the FASB and IASB were seriously considering reintroducing amortisation before abandoning those discussions in 2022.³¹

Japanese GAAP is a notable exception to the impairment approach: in Japan amortisation is obligatory, with goodwill written down to zero over a period of no more than 20 years. This difference may become more important because - with recent supportive policy - M&A activity in Japan has been increasing recently³².

³¹ <https://tax.thomsonreuters.com/news/in-a-surprising-move-fasb-drops-project-on-subsequent-accounting-of-goodwill/>

³² <https://www.japantimes.co.jp/business/2024/02/22/companies/japan-dealmaking/>
<https://www.spglobal.com/marketintelligence/en/news-insights/blog/japan-ma-by-the-numbers-q4-2023>

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