



## **METHODS OF GOODWILL ASSESSMENT AND WAYS TO IMPROVE THEM**

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| <b>ABSTRACT</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | <b>KEY WORDS</b>                                          |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------|
| For many companies, goodwill is the most significant asset, for which such concepts as identifiability and isolation are not typical. Goodwill simplifies asset manipulation, but at the same time, neither many accountants nor the management of these companies know how to accurately and correctly evaluate goodwill, since its real value is formed when the organization is sold. But goodwill evaluation is necessary, and goodwill can be evaluated in various ways. The article considers the main methods of goodwill evaluation, suggests ways to improve them and develops its own method for evaluating goodwill. | Goodwill, intangible assets, evaluation, cost management. |

### **Introduction**

Before examining the existing evaluation methods, it should be noted that the concepts of "business reputation" and "goodwill" can be used as synonyms, but only if we are talking about the cost evaluation of business reputation. Thus, any company in the process of its development reaches a point when it realizes the need to evaluate its own business reputation with high reliability. Speaking about the evaluation of the cost of business reputation, we can say with great confidence that in this case the company will calculate the amount of its own goodwill. International financial reporting standards (38 "Intangible assets" and others) state that internally created business reputation is not recognized as an asset, since it is not an identifiable resource controlled by the company, which can be reliably evaluated. In other words, a profitable, successfully operating company with strong business ties, with products in demand, constantly increasing its achievements, has no right to put its own goodwill on the balance sheet. And yet, a modern company needs to have a clear idea of how much its reputation is worth at any given moment in time.

### **Literature Review**

There are various approaches to defining the concept of "business reputation" in the academic literature. For example, in her work, I.S. Vazhenina gives the following definition of this term: it is a dynamic characteristic of a company's behavior that is formed in society over a fairly long period of time. It is formed on the basis of a set of information about how and by what methods an entrepreneurial structure

builds its behavior in certain situations. In general, business reputation can be defined as a set of opinions of stakeholders (employees, investors, creditors, analysts, authorities, media, etc.) about the advantages and disadvantages of a company, which determines decision-making in relation to it. This set of opinions exists objectively. In practice, business reputation means the "good name" of a company, taking into account its history and age of foundation, image, authority of the founders, and quality of management [1]. In the study, E.M. Korotkov understands business reputation as a holistic view of a company as a subject of a certain type of activity [2]. This opinion is formed from the perception and assessment of the results and consequences of this activity by various stakeholders and contact groups. L.G.Gabueva determined that the company's reputation is part of the intangible assets that are subordinate to the positive image of the company, the presence of permanent business connections, and brand recognition. The potential of reputation is heterogeneous in its content and depends on the attitude towards the company on the part of buyers, clients, partners, government agencies, as well as on the assessment of the quality and reliability of the products manufactured, the services of the companies, and on the assessment of the trademark, and on the assessment of the level of management [3].

Goodwill reflects only part of the capitalized costs of a business combination transaction, which can be disclosed and measured only by selling the company, as indicated by F. Piskley [4].

The last fact of recognizing goodwill as capitalized costs is emphasized by E.S. Hendriksen and M.F. Van Breda: at the same time, when a company is purchased, the acquisition and costs must be reflected in the accounting accounts [5]. In American practice, the assets of the acquired company are added to the existing ones, and the residual amount is first distributed, if possible, by adding to the accounting valuations of the assets, bringing them to market values, and the undistributed part is reflected as goodwill. Thus, goodwill is defined as an overpayment for the assets of the acquired enterprise. Although this surplus of the amount paid over the value of net assets can be called goodwill (the price of the company), it bears only some characteristics of an intangible asset, because in essence it is simply an undistributed part of the value of the assets of the acquired enterprise.

## Research Methodology

The purpose of this study is to determine the value of goodwill, induce, deduce, harmonize, and consolidate the values of the assets.

## Analysis and discussion of the results

There are several approaches to determining the value of goodwill. Let's consider the main ones in more detail.

1. According to IFRS, self-created goodwill, that is, goodwill that a company has independently calculated and reported, should not be recognized as an asset, just as self-created trademarks are not recognized. Let's say that a company is worth three times more than its net assets, then its business reputation should be recognized as zero, as a result of which the company's reporting will fully comply with IFRS requirements.

For example, there is a company whose net assets are \$50,000, and it decides to increase the value of its assets in order to obtain a bank loan. It overstates its business reputation by \$500,000 and proves that it is already worth \$550,000. But this will not play a special role in issuing a loan, since when analyzing the company's financial statements in order to issue it a loan, these \$500,000 will be eliminated from the balance sheet.

2. The value of a company's business reputation can be determined when the market value of all shares of the company exceeds its net assets. This method can be designated as the evaluation of goodwill "according to the market capitalization indicator" of the company.

$$GW = \sum_{i=1}^n m * C - Net A$$

**GW** - goodwill value;

**n** - number of types of issued shares;

**m** - volume of issued shares of the company;

**C** - share price on the current date;

**Net A** - value of net assets of the organization.

For example, if the number of shares of the company is 70,000 pieces, and the share price is \$1, when the value of net assets is \$50,000, then the value of goodwill is:  $GW = 70,000 * \$1 - \$50,000 = \$20,000$ . The disadvantage of this method is that it is applicable only to a certain organizational and legal form - a joint-stock company.

3. The next option for assessing goodwill is the "**excess profit method**". For example, the value of a company's net assets is \$100,000, and its annual net profit is \$30,000. Then the return on investment - the return on net assets will be 30% ( $30,000 / 100,000 * 100\%$ ).

For example, the industry-wide rate of return is 10%. This means that in order for an organization to receive a net profit of \$30,000 in the industry as a whole, it needs to invest:  $\$30,000 / 10\% = \$300,000$ . The resulting amount of \$300,000 is the estimated net assets of the company, which participated in receiving a profit of \$30,000 at a rate of return of 10%. Let's determine the company's excess profit, i.e. the excess of the organization's indicators over the industry average:  $30\% - 10\% = 20\%$ .

Let's determine the value of unrecorded assets that contributed to the profit:  $\$300,000 - \$100,000 = \$200,000$ .

This amount can be partially edited. For example, the assessment of bad debtors or reserves for written-off goods was incorrect. Let's assume that as a result, the company's identifiable assets were found at \$40,000. Then the goodwill value is:  $\$200,000 - \$40,000 = \$160,000$ .

Let's consider another example. Let's assume that the industry consists of four enterprises that have the same asset value of \$20,000, the same technical level and the same structure. But the profitability of assets for these organizations is different: for enterprise 1 it is 30%, for enterprise 2 – 25%, for enterprise 3 – 15%, for enterprise 4 – 10%. Let's calculate the average profitability:  $(30\% + 25\% + 20\% + 15\%) / 4 = 20\%$ . Next, given that the average price of an organization is \$20,000, then organization 1 is valued at  $\$20,000 * 30\% / 20\% = \$30,000$ . From here we determine the value of goodwill for organization 1:  $\$30,000 - \$20,000 = \$10,000$ .

The value of goodwill in the previous example can also be calculated based on this formula, namely:  $(100,000 * 30\% / 10\%) - \$100,000 = \$200,000$ . It should be noted that this formula is simplified by many appraisers.

The most complete and accurate formula for the "excess profit method" for determining the value of goodwill looks like this:

$$GW = \frac{NOI - MA * Re}{Rg}$$

**NOI** - net operating income from the organization's activities;

**MA** - the value of the company's tangible assets;

**Re** - is the capitalization coefficient of the company's net income from its main activities;

**Rg** - is the capitalization coefficient of intangible assets.

In our opinion, the formula should be changed, otherwise the value of goodwill will be equal to the value of all intangible assets that allowed the company to earn a profit higher than its competitors in the industry:

$$GW = \frac{NOI - MA * Re}{Rg} - IA$$

**NOI** - net operating income from the organization's activities;

**MA** - the value of the company's tangible assets;

**Re** - is the capitalization ratio of the company's net income from its core activities;

**Rg** - is the capitalization ratio of intangible assets;

**IA** - the value of the company's intangible assets.

Example. Let's assume that the following is known about the company:

- + Value of tangible assets (MA) = \$200,000;
- + Value of intangible assets (IA) = \$10,000;
- + For the company's equity, the average industry rate of return Y = 10%;
- + Net operating income (NOI) = \$35,000;
- + Average service life of the company's assets n1 = 25 years;
- + Write-off period for intangible assets n2 = 10 years.

Let's determine the value of the capitalization ratios of intangible and tangible assets using the Ring method. The Ring method, or its other name "straight-line recapitalization method" means returning the capital that was invested in equal shares annually, the amount of which is equal to the amount of the capital initially invested. The capitalization rate is:

$$R = Y + 1 / n$$

**n** – the number of years of operation of a particular asset. Next, we will determine the amount of net operating income of the company generated by tangible assets: **NOIMA** = **MA** \* **RMA** = \$200,000 \* (0.1 + 1 / 25) = \$28,000.

Therefore, the company's net operating income generated by intangible assets is: **NOIIA** = **NOI** – **NOIMA** = \$35,000 - \$28,000 = \$7,000.

We will determine the value of intangible assets: **VIA** = **NOIIA** / **RIA** = \$7,000 / (0.1 + 1 / 10) = \$35,000.

We will subtract from this amount the value of intangible assets that are recorded on the balance sheet to obtain the amount of goodwill: **GW** = **VIA** – **IA** = \$35,000 - \$10,000 = \$25,000.

This method is very often criticized by experts, indicating many errors that occur when using it. The main errors are mainly in the inaccuracy of determining the capitalization coefficients and the amount of net income. However, when using other methods, appraisers are not immune to these errors. Having studied many expert opinions, it can be noted that for low-risk companies, it is recommended to use a capitalization coefficient for tangible assets of 8%, and for intangible assets - 15%. For high-risk enterprises, it is recommended to set coefficients of 10% and 20%, respectively [6].

If you quite reasonably calculate the industry average rate of capital and carry out all calculations of the capitalization coefficient correctly, then in the end you can get a fairly accurate and satisfactory result.

To do this, it is necessary to carefully select similar enterprises in order to compare profitability, as well as to increase the reliability of the assessment. An analogous enterprise should be selected based on the following requirements, namely, the analogous enterprise should:

- ✚ produce similar products (works, services);
- ✚ be located in the same area (district, region);
- ✚ have very similar production capacities [7].

4. Another method is the **"excess resources method"**, which is a modification of the excess profit method. The modification of the method is that when calculating the value of goodwill, it is necessary to take into account not only the effect of using own funds, but also attracted funds.

Taking into account this addition, the formula for calculating the value of goodwill will look like this:

$$GW = \left( \frac{M}{R} - TA \right) * W$$

**M** is the company's net profit;

**R** is the industry average return on the company's total assets;

**TA** is the value of the organization's total assets;

**w** is the share of the company's equity in the liabilities structure.

Let's look at an example. Let's assume the following data is known about the company:

- ✚ Cost of fixed assets - \$20,000;
- ✚ Cost of working capital - \$25,000;
- ✚ Liabilities - \$15,000;
- ✚ Equity - \$30,000;
- ✚ Net profit - \$5,000.

Total \$45,000 (\$20,000 + \$25,000) of funds involved in the business process. The return on advanced capital is 9% (\$5,000 / \$45,000 \* 100%). Let's assume that the industry average return on advanced capital, according to the research conducted, is 7%. Therefore, the average profit of \$35,000 (\$500 / 0.07).

The amount of excess resources of the company, which are balanced by the "excess asset" is \$10,000 (\$45,000 - \$35,000). But at the same time, part of them was formed thanks to borrowed funds and this part does not belong to the organization, will be lost when repaying loans, as well as loans.

The share of the company's own funds in the structure of liabilities is 0.78 (\$30,000 / \$45,000). Let's multiply the amount of excess resources of the company by the resulting share to get the value of goodwill - the inalienable advantages of the company that are characteristic of it:  $GW = \$10,000 * 0.78 = \$7,800$ .

5. Let's consider a goodwill valuation option called **"sales volume"** valuation. To use this method, you need to know the industry average profitability ratios of companies. The formula for calculating goodwill:

$$GW = \frac{NOI - Qf * Rq}{Rg}$$

**NOI** - net operating income from the organization's activities;

**Qf** - the cost of products sold by the company;

**Rq** - the industry average profitability ratio of sales of manufactured products;

**Rg** - the capitalization ratio of intangible assets. Similar to the previous method, we will slightly transform the formula:

$$GW = \frac{NOI - Qf * Rq}{Rg} - IA$$

IA is the value of the company's intangible assets.

Let's give an example. Let's assume that the cost of goods sold is \$150,000. The value of the company's intangible assets is \$12,500. The organization's net operating income is \$30,000, and the intangible asset capitalization ratio is 20%. The organization conducted research and found that the average profitability of similar products in the industry is 10%. Let's calculate the value of the company's goodwill: VIA = (\$30,000 - \$150,000 \* 0.1) / 0.2 = \$75,000.

Let's subtract the value of intangible assets recorded on the balance sheet from this amount to obtain the value of goodwill: GW = VIA - IA = \$75,000 - \$12,500 = \$62,500.

As in the previous methods, the main problem is the difficulty of obtaining external data, namely the industry average profitability ratio.

6. By analogy, we present a formula for assessing goodwill based on the cost of production (works, services):

$$GW = \frac{NOI - Cf * Rc}{Rg} - IA$$

Cf – себестоимость продукции (работ, услуг) компании;

Rc - это средний по отрасли коэффициент рентабельности производственной деятельности.

7. The classic version of the assessment is the **balance sheet method**. The value of goodwill is determined according to the residual value assessment, i.e. the excess of the amount paid for the enterprise as a whole over the total value of its assets and liabilities, which is reflected in the company's latest balance sheet [8]. Let's assume that \$100,000 was paid for the company when it was sold, and the net assets are \$80,000 (asset value \$150,000 - liability value \$70,000 = net assets \$80,000). Consequently, the company's business reputation will be equal to: \$100,000 - \$80,000 = \$20,000.

Commenting on the balance sheet method, one cannot help but note its inconvenience and cumbersomeness.

8. There is a point of view to consider the price of goodwill in a new way, namely in the context of management accounting. At the same time, it will be easier for international companies, since with a transparent stock market, market indicators of share value are the mechanism that assesses the value of organizations. However, not all enterprises there list their shares on the stock market, that is, both there and here the value of organizations is determined by the same methods [9]. In addition to quantitative methods, there are also qualitative ones, which are mainly used for the internal purposes of the company. The purpose of qualitative methods is an analytical conclusion that helps to adjust the management of the organization so that it increases both its economic growth and its value among consumers, investors, personnel, competitors and the state. The most common qualitative methods are sociological surveys and expert assessment [10]. The method of sociological surveys implies the opinions of market analysts, media representatives, investors, consumers, and government officials. It is believed that this assessment is accurate, and other methods can only clarify the situation.

**Table 1. Advantages and disadvantages of goodwill valuation methods**

| <b>№</b>                    | <b>Evaluation Method</b>                                                                                        | <b>Advantages</b>                                                                                                                                    | <b>Disadvantages</b>                                                                                                                                                                                                                                                                                                                                                                         |
|-----------------------------|-----------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Quantitative Methods</b> |                                                                                                                 |                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                              |
| <b>1</b>                    | <b>Method of assessing goodwill based on the market capitalization indicator</b>                                | Simplicity of calculation based on the current value of the company's listed shares                                                                  | This method is applicable only to companies in the form of a joint-stock company                                                                                                                                                                                                                                                                                                             |
| <b>2</b>                    | <b>Method of excess profit</b>                                                                                  | Determining the economic effect of business reputation in business                                                                                   | Common errors associated with inaccurate determination of net income, as well as the capitalization ratio                                                                                                                                                                                                                                                                                    |
| <b>3</b>                    | <b>Method of excess resources</b>                                                                               | The method is ideal for evaluating a company before selling it                                                                                       | The disadvantage is the assumption that the company's profit is provided only by net assets, and that only its own funds create excess resources                                                                                                                                                                                                                                             |
| <b>4</b>                    | <b>Method of assessing goodwill based on the indicator of the volume of sales of products (works, services)</b> | This method is suitable for determining the current assessment of goodwill                                                                           | The calculations do not take into account any specific features of the products (works, services)                                                                                                                                                                                                                                                                                            |
| <b>5</b>                    | <b>Method of assessing goodwill based on the indicator of the cost of production (works, services)</b>          | This method is similarly suitable for determining the current valuation of goodwill                                                                  | At present, it is very difficult to reliably determine the value of the industry average indicators that are used in the formula                                                                                                                                                                                                                                                             |
| <b>6</b>                    | <b>Balance sheet method</b>                                                                                     | This method allows you to estimate the value of goodwill using the "big pot" method                                                                  | The disadvantage of this method is its cumbersomeness                                                                                                                                                                                                                                                                                                                                        |
| <b>Qualitative methods</b>  |                                                                                                                 |                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                              |
| <b>7</b>                    | <b>Method of sociological surveys</b>                                                                           | Determines the opinions of various persons about the company's activities and provides an analytical assessment of goodwill                          | The existence of these methods is determined by the assertion that goodwill is merely an image of a specific company in people's minds, which cannot be quantified; they give an assessment of "positive" and "negative", and the accuracy of the assessment itself directly depends on the sample, that is, they record a change in goodwill - for the worse or, conversely, for the better |
| <b>8</b>                    | <b>Rating assessment (or expert method)</b>                                                                     | Ratings are compiled by independent organizations, the company itself does not participate in the compilation of the rating; independent examination |                                                                                                                                                                                                                                                                                                                                                                                              |

When using the rating method, the goodwill ratings of an enterprise by independent organizations are summarized. When forming the rating, various factors that directly affect the company's goodwill are taken into account. These factors include, for example, the relationship between directors, managers and other stakeholders.

The methods available today are not universal. It is impossible to say with great certainty that the value of goodwill calculated with their help is a fairly accurate indicator. So far, there is no method that could take into account the reputation of top management, the qualifications of employees and the advantageous location of the company in the value of goodwill.

## Conclusions and Suggestions

In conclusion, it is important to note once again that goodwill in most Western companies is the most significant asset, while neither the company's management nor its accountants can correctly assess goodwill. The concept of business reputation has not yet been studied much, since in the structure of the balance sheet of an organization the share of intangible assets is quite small in comparison, for example, with the share of fixed assets and investments. As a result, this type of asset is not given sufficient and due attention. Practice shows that intangible assets are assessed much less frequently than real estate, equipment, and businesses. This is the reason for the weak development of the methodology for assessing intangible assets and goodwill in particular, both in the world and in Uzbekistan.

In this regard, the development of a universal method for assessing the excess value of a company, taking into account its individual characteristics, is an objective necessity.

Among the main requirements for such a method will be:

-  reliability and accuracy of assessment;
-  ease of use;
-  focus on the specifics of a particular industry and the enterprise itself.

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