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# The Analyses of the Value and Value Domain of Enterprise Goodwill

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### KEYWORDS

Goodwill essence,  
Value,  
Value domain

### ABSTRACT

This paper defines the concept of goodwill from the perspective of the market and the enterprise. It believes that goodwill is the market's comprehensive evaluation of enterprise's sustainable contractual capacity. It actually exists within the enterprise, is market oriented and comprehensive resource effective. This kind of effect is the potential value of the enterprise's core competitiveness. It is thought that goodwill can reduce the risk and cost of both parties in the market dealing. There is no negative goodwill, and the value domain of goodwill is  $0\sim\infty$ . It means that the enterprise is promising in the aspect of improving the goodwill value.

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## 1 Introduction

Goodwill has already appeared very early, and with the development of market economy, the value and importance of goodwill loom large. It has not only aroused much concern, but also a popular research topic in the accounting field. Till today, research on the goodwill is far from in-depth, which cannot meet the actual needs. Countries only count the goodwill in mergers and acquisitions in accounting practice, and not internally generated goodwill. This is not only inconsistent with the objective reality, but also a violation of the principles of consistency, authenticity and the importance, which cannot meet the needs of accounting information users. There is a need to study and analyze goodwill to make it clear. Understanding of the value and value domain of goodwill will directly affect the recognition and measurement of goodwill. Based on it, this paper mainly studies the value and value domain of goodwill.

## 2 The Essence and Source of Goodwill

### 2.1 The essence of goodwill

What on earth is goodwill? This has been a controversial issue to the domestic and foreign scholars for a long time. According to the definition of goodwill in the Merriam-Webster online Dictionary, the word goodwill first appeared in the 12th century [1]. As early as in 1929, the famous accounting named Canning (J.B.Canning) had proclaimed: "accountants, accounting scientists, economists,

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engineers and lawyers, were trying to define the goodwill, discuss its properties, and put forward the valuation methods of it from their own perspectives. By making a general survey of such an ocean of views, it can be found that the most prominent feature is numerous and divergent [2].” For centuries, although the academic circles at home and abroad has conducted a number of studies on goodwill from different angles, but the current understanding of goodwill still exist great differences and mostly stay in interpretative level. Views such as “goodwill value theory”, “intangible resources theory”, “excess return”, “synergistic effect theory”, and “total valuation account theory” are mainly included. However, some scholars define goodwill from the unique angle, such as: Yu Yuedong (2000) holds the view that: “Goodwill is the excess utility of human capital [3].” Tang Xiangxi considers that (2001): “Goodwill is a combination of intangible assets [4].”

Dong Birong (2004) believes that: “Goodwill is the specific intangible resource and enterprise capacity [5].” Although these theories and views have talked about some characteristics and influencing factors of the goodwill from different angles, there is still no consistent understanding of the nature of goodwill. Therefore, having a clear understanding of the nature of goodwill is the foundation of studying the value and the value domain of goodwill.

In combination, these theories and ideas put forward by the scholars reveal some characteristics and forming reason of the goodwill to varying degrees from different angles but do not reveal the nature of goodwill.

In order to have a correct understanding of goodwill, it is necessary to make in-depth analysis from the market and the enterprise and the interactive process.

From the market perspective, for the sake of successful trading, purchasers have to collect relevant information, master relevant knowledge, make a choice, bargain and so on, and also need to consider and confirm the producers’ and sellers’ reputation, the after-sales service levels, the running cost and other factors, then finally make a decision. All of these conducts need risk and cost while choosing an enterprise with good business reputation and performance capabilities is no doubt the best way to reduce transaction costs.

From the point of enterprise, to win the trust of the market, expand trade and keep their transaction cost down, the most realistic option is to improve their reputation. From the business experience, these entrepreneurs understand that to achieve such a goal, they can only use their own resources to improve their ability to adapt to the market and to satisfy the needs of the market through their own efforts. Intelligent enterprise operators clearly know that the increase of their ability and reputation can not only enable them to achieve the real deal, but also make the further trade possible, which explains why good enterprise attaches great importance to goodwill.

From the analyses above, it can be found that behind goodwill is an almost common basic fact to both sides of the deal, which is exactly the transaction risk and cost. The quality of goodwill decides the level of transaction risk and cost of both sides. Thus, we can accurately grasp the essence and connotation of the goodwill, and give it an accurate definition conforming to its nature.

Goodwill is market’s comprehensive evaluation of enterprise’s sustainable contractual capacity [5]. It comes from the enterprise. Goodwill is the potential value of enterprise ability to adapt to market development and also is the embodiment of enterprise core competitiveness. It is of great value in reducing the market risk and cost.

## 2.2 The source of the goodwill

Goodwill can reduce the transaction risk and cost. Therefore, it is of real value. But where does the value come from? Can the enterprise make a difference to increase the goodwill actively?

Though goodwill has obvious externalities, it is evaluation, favorable impression, public praise and reputation of the enterprises’ goods and services made by the market and the customers. But smart business operators clearly know that goodwill do not come out of nowhere, it finally comes from within the enterprise but not from the valuation and favorable impression of market and customers. The only thing they can rely on is their own struggle and accumulation, such as continuous publicity, enhancement of marketing efforts, clear commitment to the market and so on. Meanwhile, it is essential to have good quality, suitable product function to the customer, marketable product design, and various services satisfying customers’ needs and so on.

## 3 The Value of the Goodwill and the Formation Mechanism of Value

### 3.1 The value of the goodwill

The development of commodities trading requires that goodwill transaction has a clearly comparable price like other commodities trading. Currently, deals with the goal of goodwill abound, especially in mergers and acquisitions in the development of mixed ownership economy.

The goodwill value has particularity. The ultimate expressions of goodwill value is saving transaction cost and achieving low-cost expansion, increasing market share and bringing huge gains for the enterprise in the future, which is reflected by the enterprise sales or service performance. In the same circumstance, enterprises with high goodwill value have higher returns with the same input.

The transaction cost of enterprises refers to the occurred cost of business for the completion of the transaction; goodwill enables enterprises to reduce the transaction cost, which includes the main reasons as follows.

(1) It can reduce the cost of searching market transaction information. Under market economy, enterprises will do everything to search for market trading information because of various kinds of uncertainties, which spend a lot of search costs. Enterprises

reputation can make own business investors, creditors, customers, suppliers, the preference and support of government and other external valuable resources, making the cost of searching for and discovering the transaction object and understanding the bargain price reduce to a minimum.

(2) It can reduce the costs of bargaining and signing. Any negotiations mean bargaining, requiring a lot of manpower and material resources, including the time to prepare for negotiations, preparation and modifications of negotiation materials, round-trip transportation time and costs. Various signing ceremonies also cost much after the agreement. Enterprises goodwill makes enterprises establish long-term stable good relations with suppliers, customers and the others, greatly reducing the costs of bargaining and signing.

(3) It reduces enforcement costs, monitoring cost and the cost of imposing sanction against noncompliance. Due to uncertainties in the market, a contract is a commitment on the terms of both sides of the deal. Although the contract itself is not guaranteed to avoid the breach of terms of the contract, it can be used as legal evidence. Therefore, trading partners emphasize to perform the contract in negotiations and signing the contract, and are willing to pay a certain amount of monitoring and compliance costs. Goodwill makes enterprises establish long-term stable good relations with suppliers, customers and the others, greatly reducing monitoring costs, enforcement costs and the cost of imposing sanction against noncompliance.

Goodwill is valuable because it can enhance the trust of transactions; reduce the transaction risk and cost. Obviously, goodwill and transaction cost are two sides of a coin. Enterprises with good goodwill have rich contractual capacity, low transaction risk and cost. On the contrary, companies with inferior goodwill have weak performance and high transaction risk and cost. Goodwill is inversely proportional to transaction costs; the size of the value of goodwill determines the level of transaction cost. In this sense, the size of the integrated transaction costs actually should be the value of goodwill. It also explains why the acquirer must pay for goodwill at the time of acquisition, despite the enterprise may not fully understand the exact value of goodwill when the merger does not occur.

In addition, working in an enterprise with good business reputation will meet the moral and material satisfaction for the enterprise's senior management and employees, and even after leaving the original company they will be respected and relatively easy to seek a satisfying job.

The formation and transfer of goodwill value is different from general goods, including the following characteristics.

(1) The value of goodwill is an organic integral comprehensive resource effect for enterprises. For goodwill, if it is regarded as a product, so the starting point of the production process is register of an enterprise, the end is the termination. Its formation may be due to grasp a new production technology or create a new marketing model. However, for most enterprises, it is a combined effect of the enterprises' various human and material resources in particular management style, culture atmosphere and social environment, but also the embodiment in the enterprise's unique competitive advantage. The potential value of the enterprise's ability that the advantage brings is the goodwill value of the enterprise.

(2) Magnitude of goodwill value can theoretically increase without limitation. Under normal circumstances, if an enterprise survives and develops normally, the value of its goodwill will continue to increase with the continuous creation, maintenance, accumulation, and the promotion of various capabilities. Based on it, magnitude of goodwill value could theoretically increase without limitation. The goodwill of many enterprises with long history, salient reputation and remarkable achievements can be said priceless; some is even several times higher than its book value of assets. In the United States, according to the statistics from American scholar Michael Davis, by the end of 1992 the total amount of goodwill amounted to \$158 billion in the report of the United States 1,451 listed companies, in which 29 companies are over one billion dollars, some are more than 70% of the proportion of total capital and some even reach up to 84.6%<sup>[6]</sup>. For example, the goodwill of some enterprises in mergers and acquisitions account for 90% of the purchase price<sup>[7]</sup>, which is the objective embodies of the unlimitedness of goodwill value.

(3) Goodwill value is volatile. Goodwill is not stable. Changes in market competition, technological updating, and the emergence of new marketing pattern and so on can make a big shift in goodwill. The decline of the quality and adaptability of enterprise product and service also make the enterprise lose its competitive advantage. In reality there are also some enterprises with overnight success or being on the verge of bankruptcy at once, such as some modern dot-coms, Barings Bank in Singapore and so on.

### 3.2 The formation mechanism of goodwill value

The author thinks that goodwill is external manifestation of enterprise competence, and enterprise competence is the inner support of goodwill. Considering the perception, comprehensiveness, indexing, independence and convenience for classification and record in practice of dimensions, enterprise competence could be divided into comprehensive operation efficiency, industry potential energy and development potential<sup>[8]</sup>. Therefore, people can see through the formation mechanism of goodwill value through the analysis of the value creation process of enterprise competence.

Comprehensive performance efficiency refers to the technology and experience that enterprise can rely on to achieve specific goals. It contains professional technology, experience, management skills and experience related to enterprise production, storage and transportation, sales and other links. It includes the all-personnel labor productivity, sales profit ratio, returns on equity, profit ratio of cost, energy consumption, capital utilization efficiency, capital appreciation ability, information management level, the quality of service and production, coordination mechanism, and emergency handling ability and so on. Efficient comprehensive performance efficiency can reflect the operation efficiency and effectiveness that produced by good operational mechanism inside the enterprise. It also manifests the efficiency and effectiveness of creating value by the enterprise.

Industry potential energy refers to actual potential that the enterprise owns in the society and industry, which is embodied in the level

of enterprise products, service and market position, reflects the enterprises' business capacity and achievement from the perspective of industry and is an embodiment of the influence on the market and society the enterprise had. It includes market share, sales growth, marketing capacity, capital expansion ability, brand awareness and corporate credibility, etc. Through the lateral comparison, it directly reflects the effect of enterprise value creation, and it is also the external environment that the enterprise continues to develop. If an enterprise obtains the relative advantage of industry potential, it can easily obtain the resources that continue to develop at relatively low cost, such as the stable suppliers, broad sales channels, high-quality customer base, good government relations, and so on.

Development potential refers to the enterprises' ability to achieve long-term stable development, involving technology update, enterprise strategy, the research and development of product and technology, staff quality and corporate incentive and other major aspects. This dimension includes the investment rate of equipment replacement, strategic research expenditure, research and development investment, the condition of research and development team, the patent, continuous product ability, staff training expenditure, staff education, enterprise personnel structure and the status of employee incentive, and so on, which reflect the enterprises' learning ability, innovation ability and strain capacity. The interaction of the three abilities constitutes the potential power and source of developing sustainably, which is embodied in the enterprise operation mechanism and culture atmosphere.

Thus, comprehensive operation efficiency, industry potential energy, and the development potential are all the integral parts of the value of goodwill. If any of the three is missing, this will seriously affect the value of goodwill. Only when the three parts coordinate organically, cooperate and work together can goodwill value be promoted comprehensively so as to guarantee the realization and appreciation of the enterprise value.

## 4 The Value Domain of Goodwill

What the value domain of goodwill should be? Is there negative goodwill or zero goodwill? This is a long-debated issue in the academia circles.

### 4.1 The current view of value domain of goodwill in academic circles

There are currently two completely opposite views about the existence of negative goodwill in academic circles.

#### 4.1.1 No negative goodwill

Hendrickson (1982) has analyzed the question that negative goodwill doesn't exist logically in his book named "Accounting Theory". He thought that if the fair value of the identifiable net assets of the acquired enterprise (target enterprise) is greater than the purchase price, the owners of the target enterprise will sell net assets one by one rather than selling the whole package of net assets when positive goodwill exists<sup>[9]</sup>.

Yan Deyu (1997) considers that the nature of goodwill is asset, so negative goodwill is negative asset. However, there is no negative asset in reality, and therefore negative goodwill is an empty conception corresponding to nothing. That is to say, negative goodwill exists impossibly logically<sup>[10]</sup>. Although many countries still admit negative goodwill during M&A at present, Accounting Standards for Business Combination promulgated in China in 2006 doesn't have the conception of negative goodwill which means that the view about the existence of negative purchased goodwill is not accepted.

#### 4.1.2 The existence of negative goodwill

Some scholars believe that there is negative goodwill in practice, such as Peng Huiying (2010)<sup>[11]</sup>, Li Xiaoling (1999)<sup>[12]</sup>, Ding Jinping<sup>[13]</sup>, etc. Some scholars are suggesting that negative goodwill is the price loss which the rational target enterprise owners bear voluntarily under the precondition that the sum of transaction expense of net assets when sold singly is more than the integer retail, such as Du Xingqiang (1999)<sup>[14]</sup>.

And some other researchers' think that negative goodwill still exist even when transaction cost is put aside. The reasons are as follows. Firstly, because of some unclearly negative factors on the book of target enterprise making the future returns down, such as a large plenty of retirement pensions and relocation expenses of laid-off workers, the negative goodwill can be considered as the compensation of lower future returns. Secondly, the capitalization of Intangible assets is adopted widely to carry out scale management by some companies of good performance. Some companies make use of Intangible assets, such as enterprise brand, management mode, enterprise culture, sales channels and so on at lower price in merger and acquisitions. In this process, the purchase price is often significantly lower than the fair value of the net assets of the target enterprise. And then, the negative goodwill comes into being.

In fact, the problem of the acquired firm, such as the huge retirement pensions, relocation expenses of laid-off workers and so on, is only the mechanism problem of the state-owned enterprise, which doesn't matter with goodwill. In fact, the bargaining rather than the negative goodwill makes the purchase price lower than the fair value of net assets of acquired company.

### 4.2 The view about the value domain of goodwill in this paper

The magnitude of goodwill can be distinguished by the level of goodwill value.

Firstly, because the contractual capacity of a company can't be negative, there is no so-called "negative goodwill". If an enterprise is notorious, it couldn't continue to operate unless it has some opaque elements or runs by cheating. In mergers, the situation that is

paying for goodwill is unimaginable. The view that negative goodwill exists only because the value of the identifiable net assets of the acquired enterprise is greater than the purchase price is untenable.

Secondly, the goodwill can't be zero. Even a newly established enterprise, which has little knowledge of the market and doesn't have much popularity, can be considered as having small goodwill rather than zero goodwill. The goodwill of notorious company is approximately zero but not zero. So, zero goodwill is the limit point and only exists in theory, showing that goodwill can be ignored.

Then, goodwill doesn't have an upper limit. As we often see in fact, some enterprises always have huge goodwill in merger, which is several times higher than the real net assets, proving that the above view is reasonable.

In sum, goodwill can be any number greater than zero. The value domain of goodwill is  $0 \sim \infty$ . That is to say, we can define the value domain of the goodwill as  $(0, \infty)$ . It means that an enterprise is promising in the aspect of raising the value of goodwill.

## 5 Conclusion

Goodwill is the market's comprehensive evaluation of enterprise's sustainable contractual capacity, which comes from the enterprise. Goodwill is the potential value of enterprise ability to adapt to market development and also is the embodiment of enterprise core competitiveness. It is of great value in reducing the market risk and cost. It can enhance the credit of transaction, reduce transaction risk and cost and bring excess returns for enterprises in the future. Enterprises with good goodwill have rich contractual capacity, low transaction risk and cost. On the contrary, companies with inferior goodwill have weak performance and high transaction risk and cost. The goodwill is inversely proportional to transaction cost; the level of transaction cost determines the size of the goodwill value. Besides, it can be any number greater than zero, which ranges in  $0 \sim \infty$ , so we can define the value domain of goodwill as  $(0, \infty)$ . It means that the enterprise is promising in terms of improving the value of goodwill.

## 6 Commentary

(1) This article is some research findings of the project named "the Report and Application Research of Enterprise Resource Value and Changes in Goodwill" (NO. 12YJA630065) of Ministry of Education.

(2) The ability mentioned in this paper refers to the ability to adapt to the market and decrease the market risk and cost, not merely confined to the market sales. The reason why it is called "contractual capacity" is that under market economy condition, enterprises must adhere to market-oriented, honor an agreement in good faith and meet the needs of customer. This phenomenon is determined by the essence of goodwill. The author thinks that the difference of sustainable contractual capacity is the embodiment of the level of fulfilling social responsibilities and business ethics eventually. No matter what purchased goodwill or internally generated goodwill, the source and essence is identical. They come from the creation and accumulation in business process and are all valuable. The only difference is that the purchased goodwill comes from different enterprises with diverse culture and background, and comes between individualities but not universalities.

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