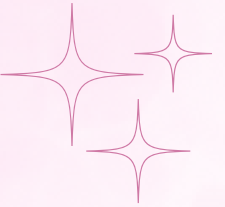




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WHAT IS GOODWILL


Goodwill is the difference between the market price paid for a target company and the fair value of its assets. Thus, if company A pays \$ 10 billion for company B, and the Fair value of company B's assets is \$ 4 billion, there will be goodwill of \$ 6 billion on company A's balance sheet after the acquisition.



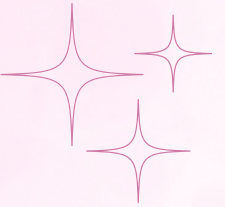


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WHY IS GOODWILL THERE



Because balance sheets need to balance. There are two key differences between the market value and accounting book value that create the need for goodwill:

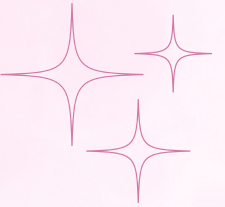




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HISTORICAL COST VS. CURRENT VALUE:

Accounting record the values of assets based on their historical cost, not their current market value. When a company acquires another company, the acquisition price is based on the current market value and needs to be recorded as such. If the acquired company's assets cannot be adjusted to reflect the price paid, the difference is recorded as goodwill.


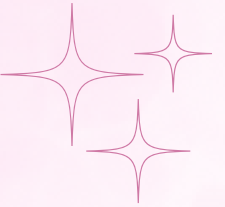




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VALUE OF GROWTH POTENTIAL

Accounting balance sheets only capture the value of a company's existing assets. However, the market value of a company includes the expected value of future growth potential. This premium paid above the book value is also recorded as goodwill.

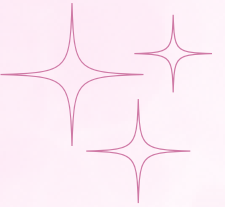


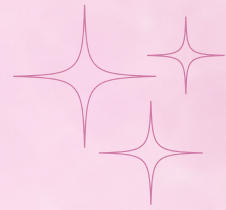


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WHAT GOODWILL MEASURES

Misvaluation of existing assets: If the value of existing assets in a company is not accurately assessed, goodwill will be present, even if there is no growth. The more misvalued the existing assets are, the higher the goodwill will be.

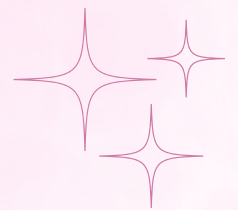


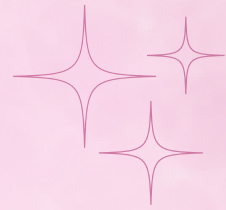


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GROWTH POTENTIAL

Goodwill increases when a company acquires another company with greater growth potential. The market value of the acquired company reflects this growth potential, while the book value does not. So, the difference is recorded as goodwill.

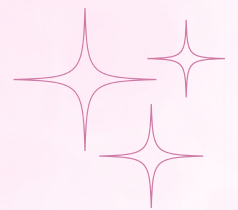




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OVERPAYMENT BY THE ACQUIRING FIRM

Research shows that acquiring companies often pay more than the actual value of the target company. This overpayment, due to various factors like self-interest or overconfidence, is recorded as goodwill.

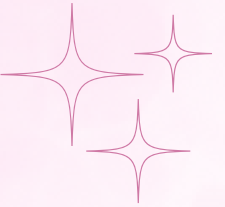





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CAN GOODWILL CHANGE OVER TIME


Yes, the value of goodwill can change over time. Since goodwill is based on market values, it can vary from period to period. The value of existing assets and growth potential can change, and any overpayment needs to be recognized at some point. However, in recent years, accountants have argued for more timely reassessments to reflect changes in the components of goodwill.



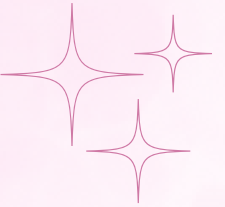


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WHY GOODWILL HAS LOST ITS RELEVANCE




Goodwill impairment has become an earnings management tool for many companies rather than a test of fair value changes. In the process, it has lost its informational content and is of little help to investors.



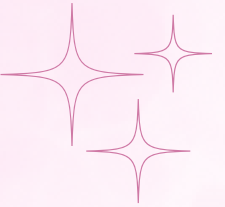


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HOW TO VALUE A FIRM WITH GOODWILL



Goodwill affects book equity, capital, and earnings. Book equity and capital change when a company acquires another, as they now include the market values of the acquired company's assets. Earnings can be influenced by goodwill impairments, which can cause significant fluctuations. Some analysts choose to ignore goodwill when calculating ROIC, but it's debated whether overpayment should be excluded.

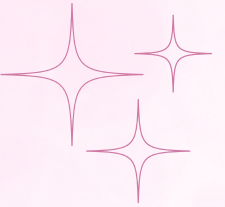





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HOW TO VALUE A FIRM WITH GOODWILL


In a DCF valuation, goodwill really has no direct effect, since we estimate the value from expected future cash flows. Thus, it is in incorrect to add goodwill on to a DCF value, since it double counts these values.



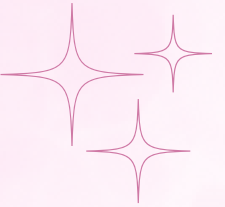


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HOW TO VALUE A FIRM WITH GOODWILL



In relative valuation, goodwill does not really affect much if you are using EBIT multiples but it can affect PE/PEG multiples, since EPS can be affected by goodwill charges. Goodwill can become a problem with BV multiples. When you do not adjust for goodwill, companies that do a lot of acquisitions will have lower price to book and EV to Book ratios than companies that grow with internal investments.





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FINAL SUMMARY ON GOODWILL

In conclusion, Goodwill does not change the underlying value of assets, and analysts should not base their decisions solely on accounting measurements of goodwill.

If a company pays too much for an acquisition, accounting treatment of goodwill cannot undo the negative consequences.

