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VALUATION METHODS OF BUSINESS REPUTATION (GOODWILL) UNDER ASSESSMENT OF INVESTMENT ATTRACTIVENESS OF THE BUSINESS ENTITY[1]

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The paper covers the description of role of business reputation (goodwill) in the assessment of the investment attractiveness of a business entity. The methodology of the goodwill valuation which allows making investment decisions is taken into account. Advantages and disadvantages of the methods are stated. The fact that the discounted cash flows method is the most reliable method of the goodwill valuation is concluded.
Keywords: *goodwill, business reputation, investment, valuation, discounted cash flows, EVA, concept of assessment of investment attractiveness of the business entity.*

Introduction. In accordance with the algorithm of the assessment of the investment attractiveness of the business entity, developed by the author, the first step in assessment is the valuation of the business reputation which is the main criterion of the investment decision-making. Business reputation is an important criterion due to the fact that a company with a «badwill» and high profitability of investments has a high risk-profile that could actually result in the absence of profit. Therefore «badwill» of a potential investee may be a reason of investor's refuse of money investing even if the potential profitability is acceptable. A business entity which has a «goodwill» and sustainable relationships with internal and external stakeholders, and also guarantees a moderate return on the investment is more attractive for an investor considering lower risk-profile.

Main part. Usually an investor has an option of investees, thus the comparative information is relevant for decision-making, including comparative data in respect of the business reputation (goodwill). Therefore, the valuation of goodwill of potential investees should be made for an appropriate decision-taking. There are several methods of goodwill valuation:

- Accounting method;
- Method of surplus profit;
- Treasury method;
- Method of practices;
- Qualimetric method;
- Statistical method;
- Option method;
- Expense method;
- Revenue return method;
- Release of royalty method;
- Discounted cash flows method.

The accounting method of goodwill valuation is usually applied under the compilation of Financial Statements. Steps of the calculation of goodwill amount in accordance with the accounting method are stated at International Financial Reporting Standard IFRS 3 «Business Combinations» [1]:

The acquirer shall recognize goodwill as at acquisition date which is calculated as the excess of a) over b) below:

a) The aggregate of:

i) The consideration transferred measured in accordance with the IFRS 3 which generally requires acquisition-date fair value;

ii) The amount of any non-controlling interest in the acquiree measured in accordance with the IFRS 3;

iii) The business combination achieved in stages the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with IFRS 3.

Accounting method of the assessment of business reputation is stated at PBU 14/2007 of the Russian accounting principles [2] as well.

This method has simple calculation steps meanwhile is rather subjective due to the fact that price of entity purchased (its fair value) may be overstated which could lead to the incorrect goodwill assessment.

Method of surplus profit is based on the assumption that the cost of goodwill is determined by the amount of profit which it generates. Thus if an entity has greater profit than the similar entity in the similar industry (or industry average), this entity has goodwill (positive business reputation) which stipulates the excess of profit. Method of surplus profit is used by professional valuation specialists and is stated in the Russian Standards of Valuation 2001 [3].

Treasury method was developed by the Internal Revenue Service (IRS) of the USA and applied for the first time in FY 1920. This method is close to the method of surplus profit and is based on the assumption that entities that operate in one industry should have similar profit. In order to value goodwill of an entity normative (industry average or profit of similar entity of similar scale) the actual profit should be compared. Meanwhile, rates of return are stated prescriptively by IRS [4]. For business entities with a high risk profile, rates of returns are equal to 10 % for tangible assets and 20 % for intangible assets (for entities with a moderate risk profile, rates of returns are equal to 8 % and 15 % for tangible and intangible assets respectively).

The advantage of Treasury method is in fact that higher rates of return for intangible assets underlie higher risk profile in comparison to tangible assets.

In accordance with Method of practices [5], the value of goodwill is calculated as ½ of remainder of fair value of the business entity and its net assets. This method is similar to Treasury method as it represents a combination of «income approach» and «the residual method». The distinction of methods is in use of prescriptive rates of returns for Treasury method, and in the fact that as per Method of practices the result of calculations is divided by 2.

Qualimetric method was proposed by V. M. Yeliseyev [6]. The method stipulates the valuation of goodwill which is based on the comparison of value of the entity's goodwill with prototypes which have the best and the worst characteristics. On the author's opinion, such approach lowers disadvantages of the methods used in the industry averages in respect of returns, as the result of such methods' application directly depends on the representativeness of the sample used for the calculation of industry averages.

The value of goodwill may be calculated through Statistical method as well. This method was proposed by B. Colass [7]. In accordance with this method, the value of goodwill equals to the composition of the annual average revenue and "K" coefficient. "K" coefficient is based on the acquisition of statistics of similar business entities. For example, for restaurant business the coefficient falls in the range of 0.6—1.2, for bakery — 0.7—0.8, for drugstore — 1—1.45.

The framework of this method is the concept of business assets proposed by the French economists. Business assets are customers, the location of an entity, management and general staff qualification, equipment, etc. It is obvious, that the majority of components represent characteristics of the business reputation. Therefore, economists linked the revenue volume and the business reputation. In our opinion, the application of the described methods for goodwill valuation could be performed only if intangible assets are considered without tangible ones in the calculation of "K" coefficient.

Black and Shawls [8] have described the method of goodwill valuation called Option method which is based on the formula of call-options including such a variable as the market value of shares. Therefore, Option method could be used only by the companies which are quoted. This is a disadvantage of the method.

In accordance with Expense method, the value of goodwill equals to expenses spent on the creation of goodwill itself which includes education of staff, research and development of management, marketing, and other technologies.

Revenue return method may be used for the valuation of part of goodwill-brand value. At first, it is necessary to divide profit generated by tangible assets and identifiable intangible assets. After that, using data obtained from the calculations of Accounting method, brand profit is separated from total profit from intangible assets. The calculated amount is multiplied by price/earning ratio. The result is the value of brand. Revenue return method has a significant disadvantage which is represented by the difficulty of separating return from brand out of total return generated by intangible assets.

Release of Royalty method is applied when the transfer of the right of brand name or logo use has taken place, and when payments of royalty are stipulated by agreement. The method is applied for the definition of brand value. During the computation, it is necessary to define sales revenue generated by business and the duration of business life-cycle. The composition of quantity of life-cycle years and annual revenue is the value of brand which generates such return.

Shareholders' welfare increase is an important characteristic of the investment attractiveness. Goodwill contributes to shareholders' value significantly. The concept of shareholders' value was developed in the concept of Economic Value added (EVA) which was proposed by Bennet Stuart [9] at the start of 1990. Nowadays EVA is used by multinational organisations, meanwhile, companies which use EVA usually show 30 % share prices growth at the first week of acceptance of EVA concept [10].

EVA concept provides managing of company's value and helps to assess its value. In accordance with this concept, business value equals to total of market value of assets and discounted cost of future EVA, and may be calculated as follows:

$$EVA = NOPAT - WACC \times Capital\ employed, \tag{1}$$

where *NOPAT* — net operating profit after tax; *WACC* — weighted average cost of capital; *Capital employed* — capital employed.

$$EVA = (ROIC - WACC) \times Capital\ employed, \tag{2}$$

where *ROIC* — return on invested capital.

The described formulas indicate the main idea of EVA on the fact that investors should be aware of rate of return on investment in relation to risks accepted, and identify whether the investment provides the return that is better than for other potential investees. Positive amount of EVA shows goodwill if return of investment in the consideration exceeds return of other investments of the similar type. Goodwill makes possible the higher rate of return.

Meanwhile, the application of EVA has both advantages and disadvantages:

Advantages and disadvantages of EVA

Advantages of EVA	Disadvantages of EVA
The adjustments made avoid distortion by accounting policies and should therefore result in goal congruent decisions.	Plenty of assumption during the calculation of WACC.
	Requires numerous adjustments to profit and capital employed figures.
Emphasise on cost of financing to division's manager.	Absolute measure (as in RI), so comparisons of several investees is difficult.
	Based on historical data, meanwhile, shareholders are interested in future performance.

Discounted cash flows (DCF) method of the goodwill (business reputation) valuation is of the greatest interest. The method is based on the assumption that future cash flows generated by the company depend on quality of company's goodwill.

In our opinion, as well in the opinion of lots of economists and specialists in valuation, Discounted cash flows method is the most acceptable and reliable method of goodwill valuation.

The algorithm of assessment of goodwill in accordance with this method is as follows [11]:

- Choice of cash flows type (interest-free or cash flows including interests);
- Definition of duration of cash flows plan;
- Analysis and planning of cash inflows;
- Analysis and planning of cash outflows;
- Analysis and planning of investment inflows and outflows;
- Calculation of net cash flows for each planned Year;
- Calculation of discounting rate;
- Calculation of cash flows during the terminal period (cash flows after the planned period);
- Calculation of net cash flows during the planned period and the terminal period;
- Value of net assets is deducted from the result calculated in the previous steps.

Discounted cash flows method has several advantages and disadvantages.

The advantages of the method are as follows:

- Clearly shows increase/decrease of shareholders' value;
- Cash flows could be hardly manipulated in comparison to profits amount;
- Considers all cash flows of the entity-potential investee;
- Considers time-value-of-money;
- Considers all cash flows of the entity-potential investee;
- Considers risk factors using discounting rate.

The disadvantages of the method are as follows:

- Complex calculations must be made;
- Result of the assessment significantly depends on the quality and reliability of input data;
- As the result of calculations is an absolute measure, investees of different sizes and scales of operations could hardly be compared;
- Is considerably based on assumptions (e. g. future sales prices, future prices of materials for production, paces of growth of entities operations, risk factors etc.).

Conclusion. While analyzing the methods of business reputation (goodwill) valuation, the following conclusion could be made: the most trustworthy and appropriate method of goodwill valuation is Discounted cash flows method. This method enables an investor to evaluate cash flows which he/she will receive if the investment is made. Meanwhile, like other mathematic models, DCF method highly depends on input data and is not straight-forward in the calculations. Therefore, during goodwill assessment, it is important to ensure that information used is accurate, complete, comparable with other investees' data, understandable, reliable, applicable and timely.

It is necessary to mention that in addition to the quantifiable assessment of goodwill, qualitative analysis is needed. It will assist in the investment decision-making process.

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Оценка деловой репутации (гудвилла) в рамках оценки инвестиционной привлекательности организации[1]

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Указана роль деловой репутации (гудвилла) в оценке инвестиционной привлекательности организации. Описаны методы оценки деловой репутации, которые применимы в процессе принятия инвестиционных решений. Определены достоинства и недостатки описанных методов. В результате анализа методов оценки гудвилла сделан вывод, что наиболее актуальным, достоверно отражающим величину гудвилла методом расчёта является метод дисконтирования денежных потоков. Описан алгоритм оценки гудвилла в соответствии с методом дисконтированных денежных потоков, определены достоинства и недостатки метода.
Ключевые слова: *гудвилл, деловая репутация, инвестиции, оценка, метод дисконтированных денежных потоков, EVA, концепция оценки инвестиционной привлекательности организации.*

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