Goodwill Hunting: How Not to Miss the Mark in Financial Accounting.

In the whitepaper "Risky Business: The Accounting Treatment of Goodwill"¹, published last year, I commented on the widespread resistance to disclosing specific intangible assets. More commonly, excess value recognised on acquisition of a subsidiary is lumped into the ambiguous intangible asset class, goodwill. In the analysis, I noted the high booked goodwill versus total enterprise value for four major UK branded chains: Debenhams, Dixons Carphone, Pets at Home, and Thomas Cook Group.

These four chains were selected because they had a high goodwill to enterprise value ratio for two years running, adopt IFRS, and are well-known brands here in the UK.

Since that article was released, Debenhams have narrowly avoided administration, Dixons Carphone has faced a 22% profit slump, Pets at Home has witnessed a surprising revival, and… hopefully no readers recently booked a holiday with Thomas Cook.

So, in hindsight, what went wrong, how did the accounting treatment of goodwill contribute to the companies’ woes, and what can other companies learn to avoid a similar fate?

Debenhams

Shortly after the completion of the whitepaper analysis last year, Debenhams’ new finance director took a decisive impairment against goodwill of $407m, which contributed to heavy losses and cancellation of dividends.

Later into 2018, Debenhams’ largest shareholder at the time - Mike Ashley on behalf of Sports Direct - offered a credit line to keep the company afloat. Debenhams declined and took a loan with its existing creditors instead. In early 2019, Mr Ashley made further credit offers in a bid to keep the company out of administration and protect his equity investments.

Debenhams again rejected his offers, and in April 2019 control passed to the company’s lenders.

The $407m one-off impairment could have been avoided through higher levels of prudence in the initial fair value exercise, or through more rigorous annual impairment tests. Furthermore, the remaining $670m of goodwill, which still exceeded the enterprise value of $634m at the time, was retained on the balance sheet at the financial year end of September 2018, just three months before Mike Ashley revealed that his lifeline offer was snubbed.

In April, Debenhams announced a company voluntary arrangement (CVA) plan which outlined proposals for warehouse and store closures as part of the company’s restructuring plan. Some landlords claim that CVAs are increasingly being used by struggling high-street chains to reduce costs and renege on contractual obligations to landlords.

In the case of the Debenhams CVA, it outlined that none of the group’s 166 stores will close in 2019, 22 will close in 2020, and a further 28 will close in subsequent years, depending on performance. In addition, it allowed Debenhams to reduce rent on 100 more stores – by between 35-50% for some. This CVA sparked a legal challenge, led by six landlords and funded by Mike Ashley who described the process of pre-pack administration as “a national scandal”. The case was dismissed in Debenhams’ favour, allowing the retailer to avoid administration and continue in the execution of gradual store closures and rent reductions in line with the CVA.

Some attribute Debenhams’ current situation with a failure to adapt to a changing competitive landscape and falling consumer confidence. While high levels of goodwill were not the direct cause of Debenhams’ issues, the historic accounting treatment did not help the situation. Goodwill is ambiguous and therefore challenging to interpret, without full knowledge of the model which underlies
its calculation and annual impairment test. This provides further evidence supporting our view that specific intangible asset valuation should be conducted by independent experts, before and in the years after a significant acquisition.

The outlook for Debenhams’ future is uncertain; in early November, the retailer launched the “Spectacular” sale online, with up to 30% off on clothing stock. Recently appointed chairman and previous exec of House of Fraser, Mark Gifford, is hoped to steer Debenhams back towards its long-term strategy of becoming a strong international, omnichannel retailer.

**Dixons Carphone**

In this year’s analysis, Dixons Carphone’s proportion of goodwill to enterprise value remains high, especially given that the latter fell further, by 42% year-on-year.

Subsequently to this year’s GIFT™ analysis, Dixons released their 2019 financial results. While goodwill is still in excess of enterprise value, an impairment of $294 m is reflected in the new goodwill figure. The impairment was caused by a higher discount rate applied in the impairment test valuation, reflecting higher uncertainty for the UK retail environment.

Again, a change in the retail environment has been a major cause of Britain’s biggest high street electrical goods retailer. A momentary boost from the closure of Comet did not last, and last month, Dixons Carphone reported a further 10% fall in mobile business revenue. Dixons have warned since June that changes in the market to post-pay contracts would severely impact profits this year.

Earlier this year, the board requested that their annual bonuses be paid in shares, deferred for two years, perhaps reflective of insider confidence in planned strategies yet to take effect. Watch this space.

**Pets at Home**

A slightly different tale for Pets at Home; the group position has improved year on year, enterprise
value has grown by 53%, and the company has repeatedly exceeded analyst expectations.

Growth has been attributed to the vet business and franchise model, indicating the importance of the strength of the brand in this recovery.

Had the excess value on acquisition of the joint venture veterinary practice unit been attributed to brand rather than goodwill, it is logical to wonder whether Pets at Home would have ever looked troubling. Investors could have more easily understood and been convinced of the future viability of the company, thus maintaining holdings and the share price.

To improve transparency for analysts and for investors, expert intangible asset valuers should be consulted before, during, and following a transaction. An independent valuer can both help to advise and provide an opinion on the value of intangible assets under question, as well as recommendations on how to grow those asset values throughout the integration plan. The alternative is ambiguity, left subject to management forecasts and assumptions.

Thomas Cook

Having failed to gain sufficient backing for a £900m rescue deal, Thomas Cook collapsed in September. As a result, 150,000 British holidaymakers were stranded overseas.

In the aftermath, executive management came under scrutiny for the high salaries and £20m in bonuses over the past 5 years – despite indications of the company’s struggles.

Due to poor performance, management took no bonuses during the most recently reported financial year – the year ending September 2018. Following a poor summer in 2018, when Brexit concerns and mild domestic weather encouraged vacationing within the UK, performance was lacklustre. And yet, despite these warning signs, the company’s auditors, EY, stated:

“We agreed with management’s conclusion that no impairments were required, based on the results of our work.”

The Financial Reporting Council probe into EY’s audit of Thomas Cook is still ongoing at the time of writing this article.

When Brand Finance conducted this year’s GIFT™ analysis, right before the company collapsed, the last reported goodwill was just shy of two times the enterprise value. However, an impairment to goodwill would have worsened the
situation, by further reducing profits and therefore shrinking the pot for executive remuneration. This may have led to rapid turnover of the executive staff and further instability, rather than solving Thomas Cook’s problems.

Ideally, Thomas Cook should have never recognised such a high value for goodwill. This goodwill value arose due to the series of acquisitions between 1993 and 2011. Assuming that the consideration paid for these acquisitions was reasonable, this value could have been allocated to other assets than goodwill. Specifically, it could have been allocated to brand, technology, contractual value, or even customer relationship value. The thorough valuation of specific identifiable intangible assets allows both investors and management to focus on investing in, maintaining, and ultimately deriving value from specific assets. The vagueness of goodwill leaves management and investors unable to interpret exactly how value will be extracted from the business combination.

At the beginning of 2019, Brand Finance valued the Thomas Cook brand at £836m. In early November, the Chinese conglomerate Fosun acquired the Thomas Cook trademarks, websites, social media accounts, and software across nearly all markets globally for only £11m. So did Fosun get an incredible bargain? Potentially. But the value of the Thomas Cook brand would have suffered significantly due to the reputational damage caused by the collapse. Customer perception of the credibility and reliability of the Thomas Cook name, built up over 178 years of operation, has been shattered by the collapse and subsequent dramas with stranded holiday makers and job losses.

Before the collapse, the brand already faced tough competition from DIY holiday sites including Skyscanner, Airbnb, Booking.com, and Trivago. Any resurgence of the Thomas Cook brand will require significant marketing investment and a business model aligned with the ever-evolving needs of the modern-day consumer.

Lessons

Many sources state that most M&A deals fail – i.e. they do not manage to make up for the initial cost. In a 2017 report, PwC cite four critical success factors of a post-acquisition integration:

1. Synergy targets are achieved
2. Integration happens within the defined time frame
3. Culture and change management is well-received
4. Strong project governance is implemented
The first factor, synergies, has a specific implication for the ongoing value of goodwill. Goodwill recognised on acquisition is theoretically representative of the future value generated through synergies between acquirer and target. In order to track and actualise these synergies, there must be realistic targets from the start. Therefore, a prudent goodwill valuation is critical not only to transparency and accuracy of financial reporting, but also to the success of an acquisition.

There are three ways to enable a prudent valuation of goodwill:

1. Pre-acquisition, understand the value of all intangible assets being acquired and establish the realistic synergies to make sure you know what you are buying and if you can integrate those assets effectively.

2. At acquisition, identify the specific intangible assets acquired on your balance sheet, rather than over-allocating residual value to goodwill.

3. Post-acquisition, if goodwill is higher than the expected synergies, and specific intangible assets cannot be identified, take a proactive impairment to goodwill.

In all three scenarios, the management’s ability to integrate a target company is assisted through deeper understanding of intangible assets. Specific intangible asset values, such as brand, should be considered through a legal, behavioural, and financial lens. This exercise forces the intangible assets to be objectively appraised, grounded in the reality of actual – rather than expected or ideal – stakeholder perceptions and business performance.

A further impact of conservatism in goodwill valuation is that investors and other users of financial statements are able to better scrutinise the specific intangible assets expected to bring value to the business.

If deeper insight into the specific intangible assets acquired is offered to investors, there is a further case for intangible value disclosure. Currently, internally generated brand value cannot be capitalised and disclosed on the balance sheet. However, an opinion on all intangible asset values could be disclosed by the board. All intangible assets, both acquired and internally generated, should be revalued every year, and boards should be required to disclose their view of those values. Such transparency would facilitate informed decision-making for investors. The impact may also be that companies would have to admit to fair value write-downs, to both tangible and intangible assets. To avoid conflicts of interest, it is therefore essential for these valuations to be conducted by independent valuers.

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1. Valuation: What are my intangible assets worth?
Valuations may be conducted for technical purposes and to set a baseline against which potential strategic brand scenarios can be evaluated.
+ Branded Business Valuation
+ Trademark Valuation
+ Intangible Asset Valuation
+ Brand Contribution

2. Analytics: How can I improve marketing effectiveness?
Analytical services help to uncover drivers of demand and insights. Identifying the factors which drive consumer behaviour allows an understanding of how brands create bottom-line impact.
+ Market Research Analytics
+ Return on Marketing Investment
+ Brand Audits
+ Brand Scorecard Tracking

3. Strategy: How can I increase the value of my branded business?
Strategic marketing services enable brands to be leveraged to grow businesses. Scenario modelling will identify the best opportunities, ensuring resources are allocated to those activities which have the most impact on brand and business value.
+ Brand Governance
+ Brand Architecture & Portfolio Management
+ Brand Transition
+ Brand Positioning & Extension

4. Transactions: Is it a good deal? Can I leverage my intangible assets?
Transaction services help buyers, sellers, and owners of branded businesses get a better deal by leveraging the value of their intangibles.
+ M&A Due Diligence
+ Franchising & Licensing
+ Tax & Transfer Pricing
+ Expert Witness

MARKETING
We help marketers to connect their brands to business performance by evaluating the return on investment (ROI) of brand-based decisions and strategies.

FINANCE
We provide financiers and auditors with an independent assessment on all forms of brand and intangible asset valuations.

TAX
We help brand owners and fiscal authorities to understand the implications of different tax, transfer pricing, and brand ownership arrangements.

LEGAL
We help clients to enforce and exploit their intellectual property rights by providing independent expert advice in- and outside of the courtroom.
About Brand Finance.

Brand Finance is the world’s leading independent brand valuation and strategy consultancy.

Brand Finance was set up in 1996 with the aim of ‘bridging the gap between marketing and finance’. For more than 20 years, we have helped companies and organisations of all types to connect their brands to the bottom line.

We pride ourselves on four key strengths:

+ Independence
+ Technical Credibility
+ Transparency
+ Expertise

We put thousands of the world’s biggest brands to the test every year, evaluating which are the strongest and most valuable.


Get in Touch.

For further information on our services and valuation experience, please contact your local representative:

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