Recent Changes in the Treatment of Goodwill

Japan has welcomed a host of amended legislation relating to business law. The changes offer corporations more options and flexibility in many important areas of business, such as M&A and governance. Importantly, the concept of goodwill in M&A transactions will be significantly altered.

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On May 1 2006, the new *Corporation Law* became effective, providing a significant development for corporate transactions. The *Corporation Law* relaxes, to a large extent, the previous framework for structures used in corporate organizations such as the corporate governance system, types of shares, distributions of earnings and other corporate elements. Corporations are benefiting by being more efficient and flexible in their organization. The *Corporation Law* is also designed to facilitate business combinations (such as mergers and share exchanges). In addition, the changes have abolished most of the provisions of Japan's former Commercial Code, which previously regulated almost all corporate matters until the introduction of the new law.

Along with the introduction of the *Corporation Law*, a number of new accounting rules have been announced by the Corporate Accounting Council of the government-run Financial Services Agency (FSA) and the private sector's Accounting Standards Board of Japan (ASBJ). Most important is the change to the comprehensive accounting rules for combining two or more businesses. This will now be known collectively as the Business Combination Accounting Standards. These rules consist of the Accounting Standards for Business Combination, Accounting Standards for Spin-Offs and the "Guidance on Accounting Standards for Business Combination and Accounting Standards for Spin-Offs". As a result, Japanese companies undertaking business combinations[1] will have enhanced transparency and quality of financial reporting.

The term '*noren*' (goodwill) is often a factor in business combinations under these frameworks. The characteristics of goodwill in Japan have become clearer in the new rules and the concept of goodwill has been slightly altered. Additionally, there will now be differences between Japan's Generally Accepted Accounting Principles (GAAP) and overseas accounting principles in relation to goodwill.

Concept of goodwill

Goodwill under Japan's Commercial Code

Goodwill was not clearly defined in Japan's former Commercial Code. The decision of the Supreme Court on July 13 1976 held that "goodwill is a set of facts or a situation with intangible value which enables a company to make more earnings than other companies". In general, goodwill is commonly considered as the intangible "excess earning power" of a company or a business. Because goodwill has its own economic value even though it is not a legal right, it was required to be reported as an intangible asset on a balance sheet under the former Commercial Code. Goodwill is recognized on a non-consolidated basis when a company acquires a business (by business transfer or corporate split between existing corporations) or merges with another company. Goodwill was prohibited from being recognized under the Commercial Code when it was created by the company itself.

How can goodwill be measured?

The Commercial Code did not provide any explanation as to how goodwill should be measured.

Based on the definition of goodwill as discussed above, the value of goodwill should be presented as "excess earnings" of a company. Therefore, it is logical that goodwill is calculated by capitalizing excess earnings using an appropriate rate (the "excess earnings method"). In a simple model, goodwill can be calculated as follows:

(i) Excess earnings = profit - business asset (net) x normal profit rate (normally, average profit rate in the relevant industry).

(ii) Goodwill = excess earnings x capitalization rate (normally, determined by taking the normal profit rate into account).

In accounting theory, this approach is called the "excess earning concept". On the other hand, there is another approach named the "residuum concept", which means that goodwill equals the difference between corporate value and the value of assets and liabilities. The so-called discount cashflow (DCF) approach would

be similar to this residuum concept. According to the DCF approach, assuming that the same amount of free cashflow is expected infinitely, goodwill can be calculated as follows:

(i) Corporate value = free cashflow / discount rate (usually, weighted average capital cost (WACC)).
(ii) Goodwill = corporate value - assets and liability.

It is anticipated that the amount of goodwill calculated by the residuum concept would also be acceptable in terms of the excess earnings concept. Because the residuum concept does not seem to fit exactly into the court precedent as mentioned above, and the provisions of the former Commercial Code prevail over any accounting theory, the amount of goodwill calculated through the discount cash flow approach was accepted under the Commercial Code as long as this amount is not markedly different from the amount calculated by the excess earning concept. In this regard, in accounting theory the residuum concept was not widely regarded as being the most common method.

Ambiguity in treatment of goodwill in Japan

Under US GAAP, goodwill is defined as the "excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired liabilities assumed" (Statement of Financial Accounting Standards (FAS) No. 141 "Business Combinations"), and the residuum concept is adopted. The International Financial Reporting Standard (IFRS) has adopted the same approach (IFRS No.3 "Business Combinations").

In the context of a consolidation process in Japan, the residuum concept is adopted for goodwill which arises upon the elimination of a parent company's investment as reciprocal accounts. In other words, in consolidation entries, a parent company's investment and its share in its subsidiary accounts, when calculated on a fair value basis, are eliminated. However, there would be a difference when the parent paid premiums to acquire its subsidiary. This difference is ultimately regarded as goodwill for the purpose of consolidation as required by the Consolidated Financial Statement Principle of Japan. (See Case 1 below).

Because the former Commercial Code did not apply to goodwill which arises upon consolidation, goodwill, for the purpose of consolidation, was not affected by the excess earning concept, which prevailed in accounting on a non-consolidated basis under the Commercial Code.

In addition, under the former Commercial Code, goodwill must be amortized equally within five years or less since the date on which it was acquired. According to the consolidation accounting standards, goodwill, which arises upon consolidation, should be amortized in less than 20 years.

Case 1

Company P acquires 100% of the shares of Company S for a cash amount of 50.

Balance Sheet
Company P

Cash	50	Stockholders' Equity	50

Company S
(Book Value / (Fair Value))

Assets	50/(70)	Liabilities	30/(40)
		Stockholders' Equity	20/(30)

After the share acquisition, the balance sheet of Company P on a non-consolidated basis will be:

Balance Sheet
Company P

Investment in S	50	Stockholders' Equity	50

No goodwill is recognized for the purposes of financial reporting on a non-consolidated basis. Upon consolidation, the fair value of the net assets of Company S (30) is set off against the investment of Company P (50). The excess of 20 is attributable to the expected potential earning power of Company S, and is recognized as goodwill. This goodwill is referred to as "goodwill for the purposes of consolidation", which was not subject to the 5-year amortization requirement under the former Commercial Code.

Balance Sheet
Company P and its subsidiary

Assets	70	Liabilities	40
Goodwill	20	Stockholders' Equity	50

Therefore, there has been an inconsistency in the treatment of the goodwill concept when considering a non-consolidated basis compared with a consolidated basis.

Corporation Law & Business Combination Accounting Standards

The new *Corporation Law* and the Business Combination Accounting Standards seem to resolve the problem of inconsistency in the treatment of the goodwill concept.

First, as for the amortization period, a subordinate regulation of the *Corporation Law*, the Regulations on Corporate Accounts, simply prescribes that assets should be amortized when amortization is necessary for such assets. It is generally understood that goodwill is classified as an asset subject to amortization[2]. However, there are no provisions as to the life span of goodwill in the regulations. It is said that the new *Corporation Law* has been drafted so as to follow

Japanese GAAP from time to time as far as accounting matters are concerned[3]. On the other hand, the new Business Combination Accounting Standards provide that goodwill, whether on a non-consolidated basis or on a consolidated basis, will be amortized in fewer than 20 years.

Second, with regard to the concept of goodwill, the Regulations on Corporate Accounts have no definition of goodwill but instead specify the cases in which recognition of goodwill is allowed, depending on the type of business combination used. In most of these provisions, goodwill is referred to as the differential between the consideration paid in a business combination by one party and the relevant stockholders' equity accounts of the other party (such as Articles 13 and 17). The Business Combination Accounting Standards have clearly adopted the residuum concept, stating that "goodwill is the excess of the acquisition cost of an acquired company or business over the net amounts assigned to assets acquired and liabilities assumed".

This means that the residuum concept has been widely adopted, both on a non-consolidated basis and on a consolidated basis. Therefore, it is possible that the DCF approach is more commonly used in all types of business combination, including a simple business transfer.

Goodwill subject to limitation on distribution of earnings

As a result of these amendments, goodwill is regarded only as a differential rather than an individual asset with its own economic value, as prescribed in the traditional excess earnings concept.

This means that the notion of goodwill as a profit-earning asset has become less important, and the number of cases in which goodwill is recognized is likely to increase as a result of business combinations. Therefore, it is expected that goodwill will be more prominent in the balance sheet of a company in future.

Japan's previous Commercial Code took a conservative position in respect of recording assets, emphasizing sound profit distribution. However, the new *Corporation Law* does not have any particular position as to the recording of assets independent from Japan's GAAP. It is therefore largely dependent on Japanese GAAP as to what type of assets should be recorded in the balance sheet and which assets should constitute distributable earnings for the purposes of the *Corporation Law*. However, in the event that a large amount of goodwill is recorded and it would constitute the basis of dividends, it is questionable as to whether such dividends are really supported by the company's actual assets.

Because of these concerns, under the Regulations on Corporate Accounts, a portion of goodwill will be deducted in the calculation of the amount of distributable earnings, namely the maximum amount which can be distributed to shareholders[4]. Therefore, because of this issue of distribution of earnings, a part of goodwill will be no longer regarded as a distributable resource under the *Corporation Law*.

Uniform measurement of goodwill in M&A

Until the Business Combination Accounting Standards were announced, there had been no established rules of accounting on a merger in Japan. The consensus, as an interpretation of the former Commercial Code, is that each asset of a dissolved company can be evaluated at an amount not more than its fair value when assets are transferred to a surviving company upon a merger. Either the purchase method or the pooling-of-interest method can be used, and it is also permissible to evaluate some of assets at fair value and others at book value.

It is generally understood that a merger was not permitted under the former Commercial Code if the amount of total liabilities of a dissolved company was more than the amount of its total assets. This is because the capital foundation of the surviving company becomes materially adversely affected during a merger when it issues new shares in consideration for the acquisition of negative assets.

Goodwill was previously recognized so as to adjust the dissolved company's asset position so that the company's total assets could exceed its total liabilities. Goodwill also served as a factor to adjust the merger ratio. This is how goodwill has been reported upon mergers in Japan. It must be said that the recognition of goodwill has been too arbitrary.

This practice has been drastically changed due to the introduction of the Business Combination Accounting Standards in April 2006. Under the new standards, whether the assets and liabilities should be carried at fair value or book value is uniformly determined and the company does not have any discretion in determining the amount of goodwill by adjusting the amount of assets or liabilities. This change improves the reliability of goodwill.

Regular amortization of goodwill

The new *Corporation Law* is silent as to regular amortization of goodwill.

The Business Combination Accounting Standards, the reason explaines that goodwill should be amortized on a regular basis explaines that because:

(i) amortization expenses match profit following a business

combination;

(ii) profits net of amortization expenses accurately present overall earnings following a business combination;

(iii) goodwill loses its economic value as time passes;

(iv) goodwill will be maintained through a corporation's business operations and will in reality be replaced by the goodwill created during this normal activity, and

(v) it is difficult to measure the portion of value lost in goodwill on a continued basis.

As a result, it should be noted that goodwill under Japan's GAAP will be subject to both "regular amortization" and "write down due to impairment", while under the US, GAAP and IFRS, goodwill is not amortized on a regular basis but must be reduced through an impairment test. This difference between the Japanese GAAP and US GAAP/IFRS tells us that goodwill will be charged earlier against income in Japan. This will have a negative impact on the fiscal periods immediately following a business combination.

It has recently been heatedly discussed in Japan as to whether goodwill can be amortized upon the closing of a business combination. The applicable Japanese GAAP at that time was not clear on this issue, although most practitioners were of the opinion that goodwill could not be amortized in the fiscal year when it was obtained unless such goodwill is minimal. The new accounting standards clearly point out that it is not permissible to amortize goodwill upon business combination unless the amount is considered to be *de minimis*.

Availability of pooling-of-interest method

Goodwill will be recognized when the relevant business combination is regarded as an acquisition and such transaction is accounted for using the purchase method. Under the purchase method:

(i) the acquisition cost of the sum of assets acquired and liabilities assumed is based on the fair value of the amount of consideration (such as cash and shares);

(ii) the acquisition cost is allocated to each asset and liability

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based on a fair value for such asset or liability; and

(iii) the remainder is recorded as goodwill.

Case 2

Company S is merged into Company P. Company P issues new shares to shareholders of Company S, with a total fair value of 50. Assume that Company P has no shares of Company S. The balance sheet of each company is the same as in Case 1 above.

Under the purchase method, the excess of acquisition cost of 50 over net of assets and liabilities (30) on fair value basis would be regarded as goodwill.

Balance Sheet
Company P (after merger)

Assets (from S)	70	Liabilities (from S)	40
Cash (P's own)	50	Stockholders' Equity	100
Goodwill	20	(original 50 + new shares of 50)	

Under the pooling-of-interest method, all accounts of Company S will be transferred to Company P on book value basis and no goodwill is recognized.

Balance Sheet
Company P (after merger)

Assets (from S)	50	Liabilities	30
Cash (P's own)	50	Stockholders' Equity	70
		(original 50 + 20 from S)	

If the transaction is accounted for by using a pooling-of-interest method, no goodwill is recognized, because all of the assets and liabilities are recorded at (appropriate) book value, and each shareholder's equity account is also transferred on a book value basis. (see Case 2 above.)

The choice of purchase method or pooling-of-interest method could give the management of a business a chance to manipulate profits, and therefore the pooling-of-interest method has been banned in many other foreign jurisdictions.

Despite the recent overseas trend to ban the pooling-of-interest method, under Japanese GAAP, it is still applied, although only in the event that the following three conditions are all met:

(i) only voting stocks will be delivered upon a business combination;

(ii) the voting rights-holding ratio of the shareholders of each party to the business consolidation should be 50:50 (however, a 5% margin on either side is permitted); and

(iii) no fact can be found which indicates a control by either party to the business contribution apart from voting rights holding ratio.

There might still be a situation in which a business combination takes place on an equal basis and it would be impossible to identify which of the parties to a business combination has acquired the other party, even after taking all matters into consideration. This is why the pooling-of-interest method is permitted in Japan as an acceptable method in very limited situations.

Concerns may be raised in connection with the adoption of the pooling-of-interest method, and therefore due care must be paid to ascertain that all three conditions are satisfied when the interest-pooling method is used. All factors must be considered, with particular attention paid in order to conclude that no factors indicate that either party can be regarded as an acquirer.

Inter-company business combinations

The Business Combination Accounting Standards also states that assets and liabilities which are transferred in cases of business combinations within companies under common control should be carried at book value rather than fair value. This was unclear under Japan's former Commercial Code. Any transfer of assets and liabilities within the same consolidation group will be eliminated for consolidation purposes, and therefore this type of transfer should be recorded at book value. This category is regarded as "transactions under common control" in the Business Combination Accounting Standards and Regulations on Corporate Accounts. This is similar to the accounting treatment under a pooling-of-interest method. However, it should be noted that there are still some cases in which goodwill will be recognized, such as where there are differences between the amount a parent's investment and the relevant portion in the accounts of its subsidiary.

Negative goodwill

Under the IFRS and US GAAP, negative goodwill cannot be recorded. Such a difference should be immediately recognized as an extraordinary gain unless it can be allocated as an adjustment of allocation to assets or liabilities. However, in Japan, goodwill can be negative when "the acquisition cost of an acquired company or business" is less than "the net amounts assigned to assets acquired and liabilities assumed". The Regulations on Corporate Accounts also support this idea by simply stating that "goodwill can be recorded as an asset or liability...," (Article 11) while the Commercial Code does not have any provisions as to negative goodwill.

The Business Combination Accounting Standards note the following points as reasons why negative goodwill can be recorded:

(i) it would be difficult to attribute negative goodwill to a particular cause;

(ii) it is possible to allocate to a particular liability when certain expenses or losses are expected to incur within a short period

of time after acquisition, and

(iii) the remaining differential should be amortized on a regular basis in contrast to amortization of positive goodwill.

This idea is consistent with consolidation accounting principles. Where negative goodwill arises upon consolidation because a parent company's investment is less than the relevant portion of the accounts of its subsidiary, the negative goodwill is recorded as a liability and will be amortized and added to income for a period under 20 years in the same way as positive goodwill.

Importance of goodwill

Japan has a unique attitude towards the recognition and amortization of goodwill. Therefore, the future impact of goodwill on a company should be carefully analyzed when business combinations between Japanese companies are discussed and when comparing such similar business combinations in another jurisdiction.

Entnotes

1 In this article, the term "business combination" is used broadly so that it includes mergers, corporate splits and share exchanges, in line with the concept in the Business Combination Accounting Standards.

2 *Regulations on Cororate Accounts*, Article 5, Paragraph 2

3 *Regulations on Corporate Accounts*, Article 3

4 *Regulations on Corporate Accounts*, Article 186, Item 1

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