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TABLES OF CONTENTS

II. REVIEWS AND NOTES

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GOODWILL UNDER THE NEW POLISH ACCOUNTING LAW

Accounting is a universal, global language of business. By means of figures and the relations between them, it describes assets and liabilities, economic processes and financial results of decisions made in business entities. The aim of this paper is to show the basic problems of accounting goodwill. Goodwill arises, under Polish law, at the moment of transfer of the tight of ownership of enterprise (purchase, bringing is assets in kind into a company, merger) and by way of leasing of an enterprise as a whole.

1. INTRODUCTION

Contemporary accounting goes beyond processing information for reporting purposes. It is also a management tool, and an instrument used to produce financial statements for business owners. Its integral part is the designing of modern accounting information systems, as well as their implementation and constant upgrading.

The growing significance of accounting in economic science and business practice has been acknowledged by bringing accounting regulations to the rank of legislative acts.

The Polish Accounting Act (hereafter called "thc Act") is an advanced piece of legislation. It draws upon solutions long applied in other market economies. Polish accounting regulations are based on the 4th and 7th EEC Guidelines and the International Accounting Standards.

Under the Act, the fundamental objective of accounting is to apply its principles with a view to provide a correct, accurate and clear presentation of a business's assets and liabilities, financial position, and profitability.

The accomplishment of this goal is made possible by specific regulations of the Act.

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2. THE NATURE OF GOODWILL

Although the term "goodwill" appeared in economic literature as early as the mid-1880s, the issue has always attracted the attention of specialists in areas ranging from law to economics, and particularly accounting. (There are few Polish language works on goodwill. The richest selection can be found in Ignatowski 1995 and other works by the same author).

It should be noted that "goodwill" has always escaped a definition. Not only has its meaning changed over the years, but it was not infrequently that a number of different definitions functioned simultaneously. For the purposes of this paper the term "goodwill" will be defined as: "the difference between the total value of a company and the sum total of the current value of its identifiable net assets".

Similar definitions of goodwill are quoted in most accounting literature. Due to its strong emphasis on a mathematical approach to accounting, this definition focuses on the figure derived from the comparison of given values.

Such an approach, which is generally accepted in accounting, will serve as a background for a further discussion of goodwill in light of the provisions of the Act.

3. ARTICLE 33.4 OF THE ACCOUNTING ACT

The Act introduced modifications to Polish accounting. One of such modifications can be found in Article 33.4. and refers to two accounting terms:

– goodwill,
– negative goodwill, classified in the Act as future earnings.

The above regulation states that:

> Goodwill represents the difference between the acquisition price of a business or its organized part and the market value (when lower than the acquisition price) of the entity's equity components or its organized part. In the event the acquisition price of a business or its organized part falls below its market value, the values of purchased fixed assets, investment, intangible assets, and inventories of the components of operating capital are recorded at acquisition prices, not lower than the net selling price of these equity components. The difference remaining after the purchase transaction is recorded as future earnings. Goodwill and future earnings are written off over a period of up to 5 years. In certain justified cases the period may be extended by entity management.

The following terms have been used by the legislator in Article 33.4.:

– acquisition price of a business entity,
– market value of a business entity,
– market value of separate assets,

– acquisition prices of the fixed assets purchased, investment, intangible assets, and inventories of components of operating capital,

– net selling prices of the fixed assets purchased, investment, intangible assets, and inventories of components of operating capital.

Each of the above terms is, to say the least, inaccurate and ambiguous, lacks proper legislative definition or appears in regulations whose language is in conflict with the manner the company (whose opening balance sheet contains goodwill) has been established.

3.1. ACQUISITION PRICE

The term "entity acquisition price" has not been defined anywhere in the Act, unlike the term "acquisition price":

> ... acquisition price is the actual price of purchasing an equity component, and is comprised of the amount due to the seller (with no merchandise and service tax added), plus, in the case of imports, public/legal charges and the costs incurred directly in the process of buying and rendering the equity component usable, complete with the costs of transportation, loading and unloading, and less price reductions (rebates, discounts, etc.) and recycled materials. In the event it is impossible to determine the acquisition price of an equity component, and especially in the case of equity components received as a gift, valuations are based on the selling price of an identical or similar item. (Art. 28.2.1).

The question therefore is whether the usage of the term "acquisition price" in the Article is the same as that of the term "acquisition price" the way the latter was used in reference to entities in Art. 33.4. of the Act.

Despite the evidently imprecise language of the Act, the term "entity acquisition price" will be used throughout the paper in reference to the real price of acquiring a business. This is in view that:

– *acquisition price is a term broader than purchase price*, since the act of acquisition may occur through legal procedures other than purchase such as inheritance, donation, gift, averse possession, awarding of assets through administrative decisions as debt recovery and through a contribution in kind,

– *the term "equity component" is not synonymous with the term "company"*.

Acquisition price is mutually determined through negotiations by the parties to an agreement. The value is documented and unequivocally specified.

3.2. MARKET VALUE OF EQUITY COMPONENTS

The legislator uses the term "market value" without ever providing its definition. The same legislator has defined "market value" in Art. 14.2. of the Corporate Income Tax Act.

> The market value of real estate, property rights and goods is determined based on average prices used in a given geographic area in trading goods of the same grade and type, adjusted for wear and tear, and the prices used in trading property rights on the dates of entering into sale agreements. (Art. 14.2).

A question arises, however, as to what extent regulations issued by the same legislator and placed in a given legal ordinance can be applied to the regulations of another ordinance. Formally, they cannot.

The term "market value" in the Act may thus be used only in accordance with the definitions quoted in the relevant literature: MARKET VALUE IS THE NUMBER OF CURRENCY UNITS OBTAINABLE FOR A GIVEN ITEM AT THE TIME OF ITS VALUATION LESS THE COSTS OF THE ITEM'S LIQUIDATION. (Kamela-Sowińska 1993, p. 74).

Despite the help of the theory and practice of accounting, the legislator failed to determine whether the term "market value" can be used in the sense of "net market value". The question is essential since the subject of the transaction referred to in Art. 33.4. is an entity, or a business comprising also liabilities which constitute debt against its assets, although from the point of view of an entity, debt is borne by a business, rather than its equity components (I have ignored here the institution of mortgage and deposits as irrelevant to this discussion).

The legislator in Art. 33.4. of the *Act* demands that the acquisition price be compared with the market value of equity components. Although the legislator failed to define "equity components", its meaning, however, can be derived from Art. 44. of the *Civil Code* which reads: "property comprises possession and other property rights". Under civil law, the term "property" refers to a specific entity and is synonymous with its "possessions". In accounting, property is defined as company's assets and thus is a term more narrow than the *Civil Code* definition of property.

All assets are subject to market valuation. These include:

- perpetual usufruct of land,
- buildings and structures,
- technological machines and equipment,
- investment projects,
- financial fixed assets,
- inventories,
- receivables and claims,
- marketable securities.

Market valuations of equity components are typically done by professional companies or by properly licensed persons.

The results of market valuations carry a certain margin of error. Yet, such valuations are usually well-documented.

3.3. MARKET VALUE OF A BUSINESS ENTITY

The legislator failed to define the term "market value of a business". Again, I shall resort to consulting the theory and practice of accounting: THE MARKET VALUE OF A BUSINESS ENTITY IS ITS ECONOMIC VALUE.

The economic value method entails valuation of a business based on estimating the anticipated future benefits to the owner. The method is commonly used in countries with stable market economies. It is based on the assumption that an entity is a good whose value depends on the future financial benefits it may generate. Therefore the value of a business is the sum total of anticipated excess earnings as of the moment of valuation.

Practical application of the earnings method may involve:

– using a number of simple methods or a simplified capitalization of earnings which due to their simplicity are commonly used in the accounting practice of market economies,

– discount methods (the so-called net value methods) which involve complete capitalization of future excess earnings with the use of a discount rate and have the advantage of properly reflecting the uncertainty of obtaining them.

Comparison of a business's economic value and its acquisition price indicates whether we will be recording **goodwill** or its **future earnings.**

In the case of future earnings, the aforementioned Art. 33.4. of the Act specifies the basis for the appraisal of only selected rather than all balance sheet items. Thus in the case of:

– the fixed assets purchased,

– investments in progress,

– intangible assets,

– components of operating capital, one should compare the acquisition price and the net selling price and determine in accordance with the legislator's instructions which one should be entered in the balance sheet.

> If the acquisition price of a business or its organized part fell below its market value, the values of purchased fixed assets, investment, intangible assets, and inventories of the components of operating capital are recorded at acquisition prices, not lower than the net selling price of these equity components. (Art.33.4.)

The acquisition price of the above equity components is recorded in the books of the business being sold. The price is documented. Is that, however, the price meant by the legislator? For the sake of maintaining the logic of this reasoning, it should be noted that under Art. 33.4. of the Act, the subject of the transaction is the business (company) considered as a whole, not the individual equity components. Did the legislator require a valuation based on the prices of acquisition of the business's equity components and their net selling prices for the sole purpose of comparing the figures and deciding which of them should be recorded in the balance sheet?

The definition of selling price is provided by the legislator in Art. 28.2.3. It reads:

> ... the net selling price of an equity component is the selling price obtainable on the balance sheet date before the merchandise and service tax less rebates and discounts, applicable excise tax and costs involved in rendering the equity component sellable and closing the sale, plus a due donation in kind; a securities market quotation may also constitute a selling price.
>
> In the event it is impossible to determine the net selling price (securities market quotation) for a given equity component, an estimate should be made of its expected net market value for the balance sheet date.

A business entity is not an equity component.

In the said Art. 33.4. of the Act, the legislator described the manner of appraising fixed assets by limiting them to fixed assets purchased. He failed, however, to specify how to record fixed assets which have been:

- received free of charge,
- awarded through an administrative decision,
- generated in the company,
- taken over as part of debt recovery,
- received as a contribution in kind.

THE CHOICE OF VALUATION METHOD FOR FIXED ASSETS OTHER THAN FIXED ASSETS PURCHASED IS AT THE DISCRETION OF A BUSINESS.

The legislator failed to specify the method of valuation with regard to:

1) financial fixed assets,
2) long-term receivables
3) receivables and claims.

Receivables and claims are especially important, since under Art. 28.1.6. of the Act, the receivables and liabilities as of the balance sheet date, including liabilities on loans taken, are valued based in the amount due.

As an aside, it should be noted that the new term "amount due" is also among the terms whose definitions were never provided by the legislator.

4. GOODWILL UNDER THE POLISH TAX LAW

The Act on Corporate Income Tax also accounts for goodwill.

Goodwill is viewed as intangible and legal assets also under the balance sheet law and tax law.

Since intangible assets are defined by the Polish legislator in two separate Acts, the term "goodwill" also appears on two separate occasions. The January 20, 1995 Decree of the Minister of Finance on depreciation of fixed assets and amortization of intangible assets and on updating fixed asset valuations (Legislative Monitor 7, item 34 and modifications) defines the term in Art. 4.2:

THE INITIAL VALUE OF A BUSINESS IS THE EXCESS OF COST OF PURCHASE OF A BUSINESS OR ITS ORGANIZED PART OVER THE MARKET VALUE OF ITS EQUITY COMPONENTS WHICH ARE PART OF A BUSINESS OR ITS ORGANIZED PART PURCHASED, ACQUIRED FOR PAID USE OR CONTRIBUTED TO ANOTHER ENTITY ON THE DATE OF THE PURCHASE, ACQUISITION FOR USE OR CONTRIBUTION TO ANOTHER ENTITY.

Analysis of both pieces of legislation reveals the differences between them. The definition of goodwill in the Decree differs in several points from the definition used in the Act.

The first such difference regards the terms "goodwill" and "acquisition price".

The Act uses the term "goodwill" whereas the Decree uses two terms:

– initial goodwill – Art. 4.2.,

– goodwill – Art. 3.3., which discusses items that may not be written off as amortization/depreciation.

The Decree explains that the "acquisition price" is the real price of an equity component. The definition of acquisition price given in the Decree is broader than the one quoted in the Act. The difference lies in the word "purchase" which places a restriction on the term "acquisition price".

Another point where both documents differ is in the depreciation of the businesses value of a business.

The new Polish Accounting Act, with its new solutions conforming to Western European standards, departed extensively from the existing legislation on corporate income tax. This is especially true in the case of depreciation, amortization, reserves, and deferred taxes.

Among the few instances of applications of the Act having direct bearing on tax laws is Article 33.4.

The amount of goodwill and future earnings, calculated in compliance with accounting principles, becomes a basis for:

1) computing the costs of obtaining income in the case of goodwill,

2) computing earnings – in the case of future earnings.

Positive goodwill (as entered to assets) should be amortized systematically throughout its life – the legislator allows a period of up to five years for its amortization; in certain cases the period may be extended by an entity's management. Under international accounting principles, this period should not exceed 20 years.

As regards future earnings, the legislator failed to specify (in both the income tax and related acts) the period allowed for recording these earnings as taxable revenue. The lack of such determination may create extremely difficult tax liabilities where all income produced in the above mentioned manner would have to constitute the taxable base at the time it is produced. Art. 7.1. of the Corporate Income Tax Act provides that all income regardless of its source is subject to corporate income tax, while Art. 12.4. of the same Act does not allow tax deductions of future earnings.

One suggestion regarding future earnings is to determine the time allowed for their write-offs as close to the life (period of consumption) of net assets acquired. In practical terms the problem proves quite complex since the assets acquired may include fixed assets depreciated over 20-year or longer periods and materials inventories designed for consumption within one year. In such a case the advisable solution would be to make use of weighted averages thus opting for an individual procedure. (This solution has been proposed by Baj 1994.)

5. CONCLUSIONS

The Act is the highest act of legislation. As such, it does not have to spell out specific solutions which may be provided in operational acts or be part of the theory and practice of accounting.

My intention in the above discussion was not to criticize the legislator or to personally attack the authors of the Act, whose contribution to the development of Polish accounting is enormous, but rather to indicate the difficulties faced by those attempting to harmonize the accounting system and bring it to conformity with EEC Directives and the International Accounting Standards.

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