

## THE ROLE OF GOODWILL IN THE FINANCIAL EVALUATION PROCESS OF COMPANIES

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### **Abstract**

*Valuing a company is a complex process, designed to determine its real economic value. In the current context, marked by heightened global competitiveness, rapid technological innovations and the increasing importance of intangible assets, valuation can no longer focus exclusively on tangible assets in the patrimony. An essential element in this equation is goodwill, which represents the additional value of a company, beyond the total assets and liabilities highlighted in the financial documents. Goodwill reflects the company's reputation, brand awareness, consolidated commercial relationships and future profitability potential. This article aims to analyze the importance of goodwill within the company valuation process, highlighting both its role in determining market value and the difficulties encountered in its precise quantification.*

**Keywords:** *evaluation, goodwill, methods, heritage.*

**JEL classification:** *M41, G32, O33*

### **1. Introduction**

*The equity method of valuation*, based on income or by market comparison — often provides a partial picture of the real financial value of a company. Tangible assets fail to fully reflect the intangible elements that make the difference between a performing company and an ordinary one. In this context, goodwill becomes an essential complement, allowing the integration of these intangible components into the total value of the company. Goodwill is defined as the difference between the market value of a company and the book value of its net assets. This difference reflects factors such as: brand reputation, customer loyalty, managerial expertise (know-how), solid commercial relationships and innovation capacity. Two types of goodwill are distinguished: acquired goodwill, recognized in the accounts following transactions such as mergers or acquisitions; internal (generated) goodwill, which, although not highlighted in the balance sheet and is difficult to measure, plays an important role in maintaining competitiveness and long-term success.

Goodwill plays a fundamental role in the financial valuation of a company, as it contributes to determining its real market value. In many situations, the market value of a company considerably exceeds its book value, and this difference is explained by the existence of goodwill. It directly influences the pricing in mergers and acquisitions transactions, where premiums paid over the value of accounting assets are justified by this intangible component. Goodwill also reflects the future potential of the company, as the valuation is not limited to past financial performance, but takes into account profitability prospects, competitive advantages and strategic positioning in the market.

However, goodwill poses significant methodological challenges. Being based on market estimates and perceptions, it is difficult to quantify objectively. There is a risk that it may be overvalued, which may lead to a distortion of the company's value. In addition, the way it is recorded and eventually depreciated in the accounting records can significantly influence the financial statements and, implicitly, the perception of investors [1].

## 2. The theoretical framework of company valuation – the concept of goodwill

The financial valuation of companies is a complex process that goes beyond simple accounting and financial analysis, also involving intangible factors that are difficult to quantify, but essential in determining the real value of a company. In the current context of globalization and the knowledge-based economy, elements such as reputation, commercial relationships, managerial know-how and innovation capacity become crucial. These are reflected in the concept of goodwill, which plays an important role in mergers and acquisitions transactions, where the purchase price frequently exceeds the book value.



Figure no. 1. - The elements that make up goodwill [15]

In the economic literature, goodwill is described as the excess of a firm's market value over its book value of net assets [2]. According to International Financial Reporting Standards [4], it is defined as an intangible asset that reflects the future economic benefits generated by assets that cannot be separately identified and recognized. Therefore, goodwill can be interpreted as an additional amount that investors are willing to pay for intangible elements such as the firm's reputation, customer loyalty and its competitive advantages.

## 3. The role of goodwill in company valuation and its challenges

Goodwill is the difference between a company's book value and its market value, a difference that often reflects investors' confidence in its potential to generate future profits. In the context of acquisitions, investors are often willing to pay a premium over the value of tangible assets, justified by the target company's intangible assets.

Goodwill thus reflects the sustainable competitive advantages that allow a company to achieve superior profits in the long term. A correct assessment of it contributes to a deeper understanding of the real economic value and viability of a business [3].

Goodwill has no physical form and, as a result, its assessment is largely subjective. Determining its value is based on estimates of future revenues, discount rates, and economic and market conditions, all of which are factors with a high degree of uncertainty. In certain situations, investor enthusiasm or unrealistic expectations can lead to an overvaluation of goodwill, which can distort the true picture of the company's value. According to international financial reporting standards, goodwill is not amortized, but is subject to an annual impairment test. This approach makes financial statements sensitive to changes in market perception, and the recognition of a significant impairment can directly affect investor confidence and the stability of share value [5].

Goodwill is an essential part of the value of contemporary companies, reflecting intangible resources that cannot be captured by conventional tangible assets. Its analysis is essential in the valuation process, especially in mergers and acquisitions transactions. By including it in the

valuation, investors and analysts can obtain a more realistic perspective on the economic potential of a company.

In conclusion, excluding goodwill from the valuation of a company would lead to a partial and often inaccurate picture of its real value. For this concept to be applied effectively, a balance is needed between methodological rigor and acceptance of its estimative nature. Goodwill reflects those premium characteristics of a business, such as brand reputation and customer loyalty, that cannot be easily quantified in financial terms. To ensure the accuracy of the value of this intangible asset, companies are required to perform annual impairment tests, identifying any losses in value that must be recorded in the balance sheet. Goodwill is calculated by subtracting the fair market value of the net assets and liabilities of the acquired company from the total price paid in the transaction. Valuing goodwill is essential in the context of business acquisitions. Even if the net assets of the target company have a fair market value, the buyer may pay a higher amount, justified by the value of intangible assets – known as goodwill. In certain situations, negative goodwill (also called badwill) may arise, when the price paid by the buyer is lower than the book value of the net assets of the acquired company. This indicates an acquisition made under advantageous conditions, usually in contexts of financial difficulty or forced liquidation[8].

Goodwill is an intangible asset recorded in the context of an acquisition, representing the amount paid in excess of the fair market value of the net assets of the acquired company. Estimating it involves anticipating future cash flows and other intangible factors that, at the time of the acquisition, cannot be known with certainty. Although this aspect does not normally create major difficulties, it becomes important when comparing the financial performance of several companies, especially in terms of reported assets or net profit. The differences arise because some companies have made acquisitions and recorded goodwill, while others have not.

Determining the value of goodwill is often difficult, being influenced by subjective estimates of the future benefits of the acquisition. In certain situations, negative goodwill can arise when the price paid for a company is below its fair market value – a phenomenon that frequently occurs in the case of companies in financial difficulties or in weak negotiating positions. In such cases, the resulting difference is recorded as income in the buyer's income statement. At the same time, there is a risk that a previously profitable company, which recorded significant goodwill, later enters insolvency. In such circumstances, goodwill loses its value completely, not being a resaleable asset. For this reason, investors tend to exclude it from calculations regarding residual equity, considering that it no longer reflects the real value of the company[9].

Correctly valuing goodwill is an essential skill for investors, but a complex one. It is difficult to determine whether the value reported on the balance sheet is justified. A careful analysis of the components of goodwill can reveal risks related to possible future impairment losses, which could negatively affect the company's financial results. On the other hand, in some cases, investors may consider the value of goodwill to be undervalued, suggesting the existence of untapped potential in the company. Unlike other intangible assets, goodwill does not have a definite life, but is tested for impairment annually to determine whether its value is still justified. If there are signs of a decrease in future cash flows or significant negative events, the company must record an impairment loss, thus reducing the value of goodwill on the balance sheet. This adjustment reduces net income and can negatively impact investor perception and the market price of the shares.

#### **4. Understanding goodwill valuation in transactions**

In the business world, the process of valuing a company is essential, especially in the context of buying or selling it. One element that is often difficult to understand is the valuation of intangible assets – and among these, goodwill occupies a central place. Although important, the subject remains complex and often interpretable. Valuing a company does not follow a standard recipe, but depends on the nature of the business and the types of assets owned. Traditionally, the focus was on tangible assets such as buildings, equipment and inventory. However, with the

evolution of business models, intangible assets have become increasingly relevant. These include: patents, trademarks, copyrights and, most importantly, goodwill. Although lacking physical form, intangible assets can contribute significantly – sometimes even the majority – to the total value of a business. Understanding how they are valued is essential for anyone involved in commercial transactions or in the financial field.

There are two main categories of goodwill[5]:

- Customer-based goodwill: reflects the company's relationships with its customers and the likelihood that they will continue to do business with the company. For example, a loyal customer base can be a valuable asset.

- Non-customer-based goodwill: includes items such as brand awareness, patents, trademarks, or other intangible assets that are not directly related to customer relationships but that contribute to the value of the company.

This distinction is important because it influences the methods chosen for valuation.

Valuing goodwill is challenging due to its intangible nature. There is no single method, but several approaches that are chosen depending on the context of the transaction[6].

1. Income Approach - This method is based on the future income or cash flows that the business is expected to generate. The most widely used technique is Discounted Cash Flow (DCF) analysis, which involves discounting the estimated cash flows using a rate that reflects the risk assumed. The result provides a present value of the business, including goodwill.

2. Market Approach - It is based on comparison with other similar businesses that have recently been sold or purchased. A commonly used method is Price/Earnings (P/E) analysis, which provides indications of the value of goodwill by comparing the company being valued with other comparable companies.

3. Cost Approach - This method estimates the cost of recreating the business from scratch – including the investment required to build the reputation, customer base and all intangible assets. It is used less frequently, usually when market data is lacking or future revenue estimates are uncertain.

4. Contractual or Legal Approach - In some situations, the value of goodwill may be established through contractual provisions, such as non-compete agreements. These agreements may include direct valuations of goodwill and are used as a benchmark in price negotiations.

Several factors can have a significant impact on the value of goodwill[10]:

- Industry and market: The industry and current market conditions directly influence the level of goodwill. Dynamic, growing industries can generate higher values.

- Historical financial performance: A solid history of growth and profitability suggests stability and reduces perceived risk.

- Quality of customer relationships: Long-term relationships, stable contracts, or recurring revenue increase the value of customer-based goodwill.

- Market position: A company with clear competitive advantages or a dominant market position naturally has higher goodwill.

Legislative or economic changes can directly influence the value of intangible assets and how they are valued[11].

In conclusion, goodwill is one of the most intangible and abstract assets. It reflects the value of a business that exceeds the sum of its tangible assets and liabilities. Specifically, goodwill encompasses elements such as market reputation, customer loyalty, brand recognition, and other competitive advantages that contribute to generating additional revenue. Industries with strong growth prospects and high demand tend to generate higher goodwill values. Market conditions can influence the overall value of a business. Factors include historical performance, competitive position, economic and regulatory changes, and the specific industry in which the business operates. Changes in any of these can affect the valuation of goodwill.

## 5. Conclusion

Goodwill plays a central role in the financial valuation of modern companies, as it reflects the intangible resources that support competitiveness and long-term sustainability. Even though it is difficult to quantify precisely, it remains an essential element in estimating the real value of a company. The inclusion of goodwill in the financial valuation methodology allows for a more accurate estimate of economic value and contributes to the substantiation of strategic decisions in the context of transactions or investments.

A company records negative goodwill, also known as badwill, when the price paid for the acquisition of another company is lower than the book value of its net assets. This type of transaction usually indicates an acquisition made under favorable conditions for the buyer, such as a forced sale or situations of financial difficulty of the target company. Goodwill is recognized in the balance sheet of the acquiring company as an intangible asset, within non-current assets. Being an intangible asset, goodwill does not have a physical form, unlike buildings or equipment, but it plays an essential role in assessing the economic value of a company. To ensure the correctness of the value of these assets, companies are required to periodically perform impairment tests. The two most commonly used methods for testing the impairment of intangible assets are: the income-based approach: consists of estimating the future cash flows generated by the asset and discounting them to their present value; the market-based approach: involves analyzing transactions and market values of comparable companies in the same industry, to determine whether the value of the analyzed asset is realistic. All of this helps to identify any possible losses in value that must be reflected in the company's financial statements.

In conclusion, understanding the valuation methods and the factors that influence the value of goodwill is essential to ensure a fair and informed transaction, for both the buyer and the seller.

Economic environment and regulations – changes in legislation or the economy can directly affect the value of goodwill. Any of these factors can have a significant impact on the final valuation of goodwill in a commercial transaction.

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