

# Analysis of Goodwill Impairment Risk of Asset-light enterprises under High Premium Merger and Acquisition

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**Abstract:** From the perspective of goodwill generated by mergers and acquisitions, this paper analyzes the reasons for the huge goodwill generated by high-premium mergers and acquisitions of asset-light enterprises and the influencing factors of goodwill impairment, finds out the adverse consequences of goodwill impairment, and puts forward some measures to prevent the risk of goodwill impairment caused by high-premium mergers and acquisitions, so as to make enterprises more objective and rational in future mergers and acquisitions and minimize the negative impact of high-premium mergers and acquisitions.

**Keywords:** High premium M&A, Impairment of goodwill, Asset light enterprise.

## 1. Introduction

Influenced by a variety of complex macro environmental factors, all kinds of large and small enterprises seek for future development space through mergers and acquisitions to improve their overall competitive advantages. "No mergers and acquisitions, no goodwill", goodwill is a potential unidentifiable economic value, can bring uncertain excess profits for the enterprise in the future for a period of time. Mergers and acquisitions in China's capital market surge, resulting in the scale of goodwill expand year by year, forming a huge goodwill bubble. Behind the merger and acquisition with high premium is the high valuation of the acquired assets, which is often accompanied by high performance commitment. When the operating conditions of the market change, goodwill may be impaired, damaging the interests of enterprises and causing huge losses to investors.

## 2. Reasons for the Formation of Huge Goodwill Under High Premium merger and Acquisition

### 2.1. Asset recognition of asset-light enterprises.

Driven by knowledge and science and technology, the original resource structure of enterprises has been transformed. Asset-light enterprises gain profits through intangible resources such as patented technology, human resources, sales methods and brand image, and enhance their core competitiveness. However, as appraisal agencies cannot measure the value of a company with tangible assets as in traditional industries, the book value of enterprise assets cannot represent the real value of the enterprise. Because of the intangibility of competitive resources, there is a certain difference between the overall valuation and the real value of asset-light enterprises, which eventually leads to high premium and high goodwill.

### 2.2. High performance commitment pushes up the merger premium and forms huge goodwill.

In view of the reasons for the failure of M&A in the past,

the acquirer usually requires the acquiree to make performance commitment, which has gradually become an indispensable part of the M&A process. Performance commitment was originally set up to protect the acquirer, which can reduce the potential moral hazard in M&A to a certain extent. However, with the development of M&A market, the signed performance commitment not only violates the original intention, but also creates huge goodwill. The acquired party intentionally increases the promised performance to achieve the purpose of raising the enterprise valuation, and takes high performance promise as a signal of good business performance and a means to attract the acquirer. The high premium is exchanged by high performance promise, resulting in huge goodwill. Unrealistic high performance promise leads to goodwill impairment due to low completion rate, thus affecting profits.

### 2.3. Value assessment choice income method.

When choosing the income method as the valuation method of M&A, its applicable basis is: the company can develop steadily, the capital is proportional to the profit, the future income and risk of the enterprise can be predicted and can be accurately measured. Income method is based on a large number of assumptions in the evaluation, such as the support and guidance of relevant national economic policies, stable transaction environment, no significant changes in industry development, the acquired party can maintain the current market competitiveness, etc. Evaluation institutions often make optimistic predictions on the development prospects and future revenue of the acquired party, ignoring risks such as market saturation and product life cycle. It is unreasonable to predict the good development earnings of the company based on the historical earnings information. Due to the high unpredictability of the forecast, the enterprise value may be overestimated, resulting in the formation of high premium and huge goodwill. If the assumptions based on the evaluation change, or the business conditions of the enterprise start to deteriorate and cannot achieve the expected performance, then the huge goodwill brought by the high premium will be subject to impairment insurance.

### **3. Analysis of Influencing Factors of High Premium on Huge Goodwill Impairment**

#### **3.1. Guidance of national policies.**

China Securities Regulatory Commission revised relevant M&A policies in order to inventory the surplus assets in the market, stimulate the development of enterprises, and promote the continuous occurrence of M&A and restructuring activities. Influenced by the "going out" policy of the state, M&A and restructuring activities have become increasingly fierce in overseas markets. With the gradual relaxation of the criteria for the recognition of M&A, China's M&A market continues to develop under the influence of national policies, and a huge amount of goodwill continues to accumulate. Changes in specific requirements and standards of goodwill impairment will also cause goodwill impairment. The CSRC has put forward more requirements to make the impairment of corporate goodwill more detailed and specific. Through goodwill impairment, enterprises can conveniently operate their own performance. The interval is compressed. In addition, more than half of the members of the Accounting Standards Committee agree with the amortization of goodwill, and they all believe that the goodwill under the amortization method can be more timely and accurate. However, for enterprises with excessive amount of goodwill, if they start amortization, it is likely that the amount of goodwill amortization will be greater than the profit, leading to the decline of performance and even the beginning of losses. Therefore, under the influence of these policies, Enterprises will first set aside a large amount of goodwill impairment to prevent the serious economic consequences of goodwill amortization.

#### **3.2. High performance promises fail to meet expectations.**

In the process of M&A, the impairment of corporate goodwill is not necessarily related to the performance commitment signed by the enterprise, but the acquirer will pay an excessive premium and determine a higher goodwill because of the existence of the performance commitment. The asset-light industry is characterized by high growth and high market heat, and the acquirer is concerned about its future profitability. To a certain extent, performance commitment can be used to encourage the acquired party in the future, so that it can operate the enterprise diligently and protect the interests of the acquirer. However, the acquired party will increase the M&A valuation through unattainable high performance promises, while the acquirer will complete the M&A as soon as possible in order to obtain immediate benefits and pay no attention to potential risks in the future. In this way, relatively high performance promises are likely to cover up the real value of the enterprise. If the acquired party fails to fulfill its performance promises or the overall profitability of the enterprise declines after the performance promises are valid, the acquiring party will have the risk of huge goodwill impairment.

#### **3.3. The synergy effect after the merger is overestimated.**

After the merger and acquisition, both parties should integrate technology and customer resources, so as to realize the complementary advantages of both parties in intangible

resources, so as to maximize the synergistic effect. However, high premium generates high goodwill, which will lead to excessive false growth of enterprise assets, and the business scale of the merger and acquisition party will expand rapidly due to the newly added merger and acquisition business. If the two sides in the production operation and management concept can not achieve a real fit, it will be difficult to achieve the control of impairment risk. After the completion of the merger, the acquiring party should timely adjust the original production and operation mode, otherwise there will be differences in business management, customer resources, research and development design and other aspects, resulting in decision-making conflicts, resource integration effects can not reach the expectations, management costs will gradually rise in the future period of time, affecting the play of synergies. After the completion of the merger, the merger parties may have conflicts in the integration, and the integration result cannot be determined. The operation scale and performance of the merger party will be affected to a certain extent. Therefore, an optimistic attitude towards the synergistic effect will cause the value of the acquired party to be overestimated, with a high premium, a huge amount of goodwill drawn and a high risk of goodwill impairment.

#### **3.4. The existence of earnings management motivation.**

Our country's accounting standards stipulate that enterprises shall conduct impairment test for merger and acquisition goodwill at the end of each year. However, the requirements for impairment test methods are not detailed and the content is not clear and clear. In practical life, goodwill impairment test has strong autonomy and is easy to manipulate. The recoverable amount of an enterprise is usually measured by the income method, and whether the impairment of goodwill is determined by comparing the recoverable amount with the carrying value of goodwill. Therefore, when choosing the time point of impairment, the management will give priority to factors closely related to its own interests and be more inclined to implement earnings management through goodwill impairment. With the help of the "elasticity" loophole of relevant impairment provisions, the company can avoid the impairment of goodwill when the performance increases, and maintain a stable profit level in the financial statements when the performance declines or the profit is negative through three means: large amount of provision, little provision and no provision for the impairment of goodwill.

### **4. Analysis of Goodwill Impairment Consequences of High Premium M&A**

#### **4.1. Decline in business performance.**

The impairment of goodwill is included in the asset impairment item in the financial statements, so the net profit of the enterprise will be affected, and the business scale and performance of the enterprise will decline due to the impairment of goodwill, resulting in huge losses. Goodwill impairment will affect the company's profit at the same time. Bring unpredictable financial risks, but also make the interests of investors by varying degrees of damage, so that they gradually lose confidence in the company's operation.

## **4.2. The decline of the stock price and the loss of interests.**

Goodwill impairment means that the performance of an optimistic enterprise acquired at a high price has not reached the previous expectations. Therefore, the goodwill impairment of a high premium acquisition will cause the change of the stock price of the enterprise, which is not conducive to the development of the enterprise and will make the enterprise face the risk of performance loss. In the face of the rise and fall of stock prices, the small and medium investors who are optimistic about the development of enterprises are in the passive side, and after the enterprise's goodwill at the end of the year, they will bear the loss of stock prices, lose confidence in the enterprise and cause the loss of capital.

## **5. Measures to Prevent Goodwill Impairment Risk of High Premium M&A**

### **5.1. Strengthen the evaluation and investigation before merger and acquisition.**

Strengthen the investigation before merger and acquisition, reduce the risk of "high goodwill" and "high goodwill impairment" brought by industry merger and acquisition, and lay a good foundation for the subsequent goodwill value management. The investigation of the situation before the merger not only includes relevant national policies, industry development prospects, the sustainable development of the acquired party and its future trend, but also evaluates whether it has enough ability to integrate the resources of the merger and not blindly optimistic estimate the future benefits of the acquired party. Investigation can reduce the possibility of M&A mistakes, reduce the waste of resources and improve the efficiency of M&A.

### **5.2. Treat enterprise valuation objectively.**

The valuation of the acquired party will affect the establishment of the merger consideration, so we should treat the valuation result objectively and not over-rely on it. First of all, experienced professional appraisers should be hired to evaluate the acquired party, so as to reduce the overestimation of the value of goodwill caused by excessive valuation, which makes the enterprise bear the risk of excessive impairment of goodwill. Secondly, the unique nature of the asset-light industry should be taken into account to choose the appropriate valuation method. The valuation of asset-light is different from other asset appraisals that can be measured accurately. More and more complex factors need to be considered. The impairment risk of M&A goodwill due to information asymmetry. Thirdly, due to the difficulty in evaluation, the acquirer may find it difficult to obtain the real financial information of the acquired party, and the acquired party may maliciously raise the acquisition consideration price. Therefore, the evaluation institution must take a cautious attitude to verify the financial data provided by the acquired party and make a fair evaluation. Finally, in the evaluation process, the evaluator should take the situation of the acquired party into full consideration, not only the reliability of relevant financial data, but also the non-financial information of the integrated business, especially the internal product structure, core competitiveness and development

direction of the company.

### **5.3. Correctly view and sign reasonable performance commitments.**

At present, one of the important reasons for the impairment of huge goodwill is that the acquired party cannot fulfill its performance commitment. High performance commitment increases the acquisition premium of the acquired party to a large extent and raises the valuation of the acquired party. Performance commitment plays a key role in the merger and acquisition of enterprises, so we should treat the performance commitment rationally, should not easily believe the signed performance commitment, and do not fully believe the performance of the acquired enterprise, the full play of synergies after the merger can avoid the risk of goodwill impairment. When signing a reasonable performance commitment agreement, at least the following two aspects should be considered: first, the performance promised by the acquirer is consistent with its daily profitability; Second, to ensure that accountability mechanisms are clear, performance pledges must not be accompanied by other backstop agreements. Only by making objective, real and achievable performance commitments can the acquisition better ensure the positive impact of the merger on both parties and avoid the risk of goodwill impairment.

### **5.4. Optimize the subsequent impairment test of goodwill.**

Due to the unique characteristics of asset-light enterprises, the testing of goodwill impairment at the end of the period is easy to generate high goodwill in the process of merger and acquisition, but the testing method is highly independent, difficult, not transparent and controllable, and it is relatively easy to make use of the loopholes in the provisions of goodwill impairment to conduct earnings management on corporate profits. Therefore, it is very necessary to perfect the subsequent impairment test of goodwill. The value of goodwill before goodwill impairment should be amortized in reasonable stages. Once goodwill impairment occurs, a series of processing of "goodwill impairment" should be done. To a certain extent, amortization by installment can reduce the intangible assets recognized as goodwill to the corporate profits. Under the current method, it can compress the autonomy space of estimating the expected return of the enterprise, selecting the time point of impairment, and calculating and drawing the amount of impairment, which will reduce the autonomy of the enterprise and fundamentally eliminate the idea that the enterprise management tries to implement earnings management with the help of goodwill, so as to achieve the purpose of reducing the impairment of goodwill. At the same time, at the beginning of M&A activities, the acquirer will be more cautious in the valuation of the enterprise, so that the goodwill generated in M&A activities return to reasonable.

### **5.5. Pay attention to the integration of resources after the merger.**

Merger and acquisition activity is the most direct and effective way to improve corporate earnings and change the main business items of enterprises. Its purpose is to realize resource complementarity and development with the help of high-quality resources. If the acquirer fails to integrate resources in a timely and effective manner, it will eventually lead to the loss of resources, loss of competitiveness and

enterprise depreciation of the acquirer, resulting in a large amount of goodwill impairment. Merger and acquisition is not only limited to the completion of the merger plan, but also the subsequent resource integration is very important. Strengthening the resource integration after merger can achieve the purpose of enterprise value-added and reduce the risk of merger and acquisition. Resources can be integrated from product brand, human resources, research and development technology, corporate culture and other aspects. When selecting the enterprise to be acquired, we should give priority to the industry and market environment, select the acquisition target from our own perspective, coordinate and integrate the strategic target according to the future development direction, so that the synergistic effect can play the maximum role.

### 5.6. Intensify external oversight.

The most important way to avoid the risk of goodwill impairment is to fundamentally control the generation of huge goodwill and strive to curb "high premium" mergers and acquisitions. Accounting firms should pay more attention to the asset-light enterprises with relatively large amount of goodwill at the end of the period, and check whether the confirmed goodwill and the amount of impairment provision are accurate and reasonable. Important participants, including the firm, should conscientiously perform their duties. Evaluation institutions should accept stricter supervision, maintain independence in the process of enterprise merger and acquisition, avoid possible insider trading and artificial manipulation, and make real judgments according to the actual situation, so as to prevent excessive accumulation and huge amount of unreasonable goodwill. The impairment of goodwill, appraisers need to take responsibility for their own judgments and increase their sense of responsibility to ensure that companies are valued prudently and reasonably. Before the merger and acquisition, the regulatory department should immediately send a letter to inquire the parties of the merger about the inconsistency in the performance promises. Unless there is real evidence to support such inconsistency, the implementation of the merger and acquisition should be canceled. The regulatory authorities must improve the attention and supervision of mergers and acquisitions with high performance commitments and severely punish those enterprises that change or evade performance commitments without authorization.

## 6. Conclusion

To sum up, M&A with a high premium is bound to cause high impairment risk, especially in the asset-light industry, where the high premium generated after M&A is seriously inconsistent with the actual value, which will be followed by a huge amount of goodwill impairment, which will exist due to the existence of a high premium. The higher the premium, the greater the risk of impairment. A large amount of goodwill impairment will eventually lead to the business performance of the enterprise is not good, loss of profitability and many other serious economic consequences. Due to many complex factors, the expected synergies cannot be achieved in M&A. Therefore, if the asset-light industry makes good use of the "double-edged sword" of M&A, it can be fully aware of the risks of M&A and make prudent decisions. Paying attention to resource integration after M&A can effectively prevent the risk of goodwill impairment and timely deal with other possible M&A risks.

## Acknowledgment

Fundamental project: Auhui University of Finance and Economics Postgraduate Research Innovation Fund Project (ACYC2021513)

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