THE ACCOUNTING TREATMENT OF GOODWILL: WHEN WILL FASB STOP CHANGING THE RULES?

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Abstract

The accounting treatment of goodwill is one of the most researched accounting issues. Throughout the history of generally accepted accounting principles (GAAP), the accounting rules related to goodwill have changed many times. This qualitative research paper analyzed the authoritative accounting literature to determine how and why the accounting treatment of goodwill has changed so often. From ARB 24 published in 1944 to the Accounting Standards Updateapproved in August 2011, goodwill passed from being a wasting asset be amortized to an asset to be annually tested for impairment. The study found that the accounting treatment of goodwill has been constantly changing due to the complexity, controversies, and costs of testing goodwill for impairment. Despite the recent Accounting Standards Update, the accounting treatment for goodwill will continue to change.

Keywords: Accounting Treatment, Goodwill, SFAS No. 141, SFAS No. 142, Measurement, Impairment, Business Combinations, Intangible Assets

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Introduction

Intangible assets are long-term assets that have no physical substance but a value based on the rights or benefits conferring to the owner (Needles, Powers, and Crosson, 2011). Intangible assets include copyrights, trademarks, franchises, patents, and goodwill. Goodwill is the excess of the fair value of the consideration exchanged over the fair value of the net assets acquired. The fair market value is defined as the price that would be received to sell assets or paid to transfer a liability in an orderly transaction between market participants at the measurement date (Spiceland, Sepe, and Nelson, 2013). Goodwill can emerge from a company's clientele, its reputation, the expertise of its employees and management, its physical location, and other favorable features (Spiceland et al., 2013). In the Statement of Financial Accounting Standards No. 141, *Business Combinations*, the Financial Accounting Standard Board (FASB) defines goodwill as an asset that represents the future economic benefits arising from other assets acquired in a business combination that the entity cannot identify individually or recognize separately (FASB, 2001a, para.3). This qualitative research study analyzed the authoritative accounting literature to determine how and why the accounting rules related to goodwill have changed so often over time.

Problem Statement

Goodwill and other intangible assets appearas long-term intangible assets on the balance sheet of an acquiring company. In many companies, they represent a large amount of money. Therefore, goodwill and other intangible assets must be properly accounted for. One of the first major U.S. generally accepted accounting principles (GAAP) dealing with the accounting treatment ofgoodwill was issued in Accounting Research Bulletin (ARB) Opinion 24 in 1944. At that time, the ARB viewed goodwill and other intangible assets as wasting assets with finite useful life, and thus the amounts assigned to them should be amortized in determining net income. Over the past decades, mergers and acquisitions (M&A) have increased and accounted for billions of dollars. With the increase in M&A, the accounting treatment of goodwill has presented a lot of complexities and gaps that had to be addressed in order to meet the needs of preparers and users of financial statements. The Financial Accounting Standards Board (FASB) viewed goodwill and other intangible assetsnot as wasting assets but as important economic resources. Since the beginning the twenty-first century, several important changes have been made in the treatment of goodwill. This study identifies how the accounting treatment of goodwill has changed and why it has kept changing over time.

Background of the Study

According to Garcia (2007), there have been four different accounting treatments of goodwill throughout the U.S. history. These four accounting treatments are based on two underlying assumptions about goodwill. In the first assumption, goodwill is viewed as an asset. In the second assumption, goodwill is not considered an asset. Ding, Richard, and Stolowy (2007) noted thatthe two assumptions of goodwillgave rise to four alternatives:

1. Goodwill should be recognized as an asset at cost and amortized over its useful life;
2. Goodwill should not be recognized as an asset or should be written-off immediately against reserves;
3. Goodwill should be recognized as an asset, be retained permanently in the balance sheet, and possibly adjusted (written down); and
4. Goodwill should be immediately or rapidly expensed against earnings (Ding et al., 2007).

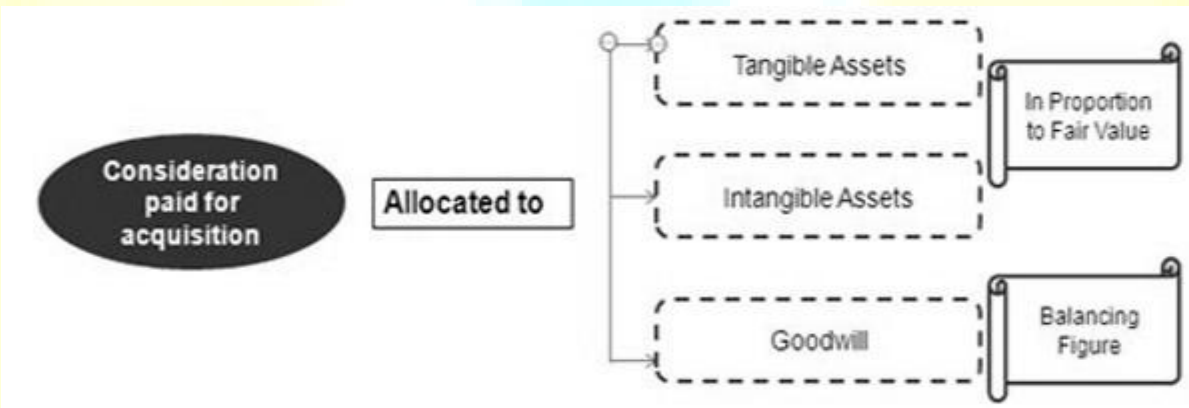
The American Institute of Accountants (AIA) published the first U.S. accounting literature related to the treatment of goodwill in 1917 (Ding et al., 2007). Later, in 1944, the AICPA, which replaced the AIA, issued the Accounting Research Bulletin No. 24, *Accounting for intangible assets*. This Bulletin considered goodwill as a cost that expires and that should be assigned to future revenues. The Bulletin required that goodwill be amortized against the revenues (Garcia, 2007). In 1950, ARB No. 40, *Business Combinations*changed the treatment of goodwill and requiredthat goodwill bewritten-off. When ARB No. 43 and ARB No. 48 were published in 1953 and 1957 respectively, they made it impossible to write-off goodwill (Garcia, 2007). In 1970, the Accounting Principles Board (APB) issued APB Opinion No. 16, *Business Combinations*. One of the objectives of this statement was to recognize and measure the goodwill acquired in the business combination or a gain from a bargain purchase. This Opinionoffered an entity two alternatives to account for their combinations: the purchase method and the pooling of interest method (Powers, 2000).Under the pooling of interest method, it is difficult to identify the acquirer. Under the purchase method, the acquiring company is identified and it records the acquired assets and assumed liabilities at fair value. This method often involves the recognition of goodwill (Powers, 2000; Weatherholt and Cornell, 1998).

In 1970, the Accounting Principles Board issued APB Opinion No 17, *Intangible Assets.* The purpose of this Opinion was to provide guidance on the accounting treatment of intangible assets acquired individually or with a group of other assets (Anonymous, 2001). The Board perceived goodwill and other intangible assets as wasting assets. It considered that goodwill had a limited life and therefore the amount assigned to goodwill of should be amortized over an arbitrary period of 40 years using the straight-line method (Weatherholt and Cornell, 1998). However, the costs of other internally developed assets with indeterminable life would be expensed when incurred (Atkinson and McGaughey, 2006). APB Opinion No. 17, *Intangible Assets* provided little guidance about the determination and measurement goodwill impairment. As a result, the accounting for goodwill impairments was inconsistent and incomparable, and did not provide useful information to investors, creditors and other users of financial statements (Anonymous, 2001). APB Opinion No. 17 only recommended that firms review all purchased goodwill for overstatement two years after acquisition date. The overstatement review would be required only after one year and updated quarterly, if the acquirer still believed an overstatement existed (Weatherholt& Cornell, 1998). At the end of the 1990s, goodwill and other intangible assets have increased significant in proportion of assets acquired in business transactions and become increasingly important economic resource for many firms. Consequently, financial analysts and other users of financial statements needed useful information on goodwill and other intangible assets, which the APB Opinion No. 17 did not provide (Anonymous, 2001).

In 2001, the FASB issued the Statement of Financial Accounting Standards (SFAS) No.141, *Business combinations* to replace APB No. 16. In 2007, FASB revised SFAS No. 141 to address more concerns. SFAS 141 requires the acquirer to recognize goodwill as of the acquisition date and to measure it as a residualvalue (FASB 2001a, para.34). In order to improve the faithful representation and completeness of the information provided in the financial statements about the asset acquired in a business combination, SFAS No. 141 requires goodwill to be recognize separately from the acquisition-date fair values of research and development assets acquired. This Statement eliminates the pooling of interest method and requires entities to use the purchase method to account for their business combinations.

Theoretical Framework

Abeysekera (2012)argues that the use of market value for the measurement ofpurchased goodwill for recognition in financial statements is a mere artifact and a response to thecontemporary paradigm rather than a measure of the accurate financial worth of purchased goodwill. Based on fair values at the date of acquisition, an acquiring company must allocate the purchase price to the assets acquired and liabilities assumed. The excess of the cost of acquisition of the entity over its actual book value is recorded as goodwill.The intangible assets that are recognized separately as goodwill must be appropriately valued for the purpose of financial reporting.



Purchase Price Allocation (n.d.) Retrieved from http://companyvaluation.in/deciphering-the-valuation-code/purchase-price-allocation/

It should be noted that under IFRS there is no separate provision for accounting intangibles. According to Hadjiloucas and Winter (n.d.), the newly introduced IFRS 3 is a very significant extension of this shift to enhanced transparency. Its impact should not be underestimated. IFRS is therefore becoming the new accepted language for financial reporting. There are also significant pressures to converge the U.S. and International Financial Reporting Standards to establish one set of global standards.

The Financial Accounting Standards Board (FASB) examined two methods of accounting for businesscombinations, namely the purchase method and the pooling of interest method, and then issued a specialreport stating that the existence of the two methods to account for identical transactions can lead to firmsmanaging accounting for the transaction with the method that produces desirable results for them (Abeysekera, 2012). This means that the same company's balance sheet can look completely different under different jurisdictions' accounting rules, notwithstanding the fact that each purports to show a true and fair view. The additional disclosure now mandated by IFRS 3 means that the market can expect to receive valuable in-depth information, helping them to assess more accurately exactly what companies have acquired. Hadjiloucas and Winter (n.d.) noted that while this is clearly a positive step, a major gap still exists in the reporting of intangible assets because no jurisdiction yet allows a company to place a value on its internally generated intangible assets.

Principal changes of IFRS 3 at a glance

- All business combinations are to be accounted as acquisitions - no more merger accounting.
- Goodwill is no longer amortised but subject to rigorous annual impairment tests.
- More intangible assets will be identified, valued and recognised on acquisition.
- Detailed disclosures about transactions and impairment testing are required.

Hadjiloucas, T. and Winter, R. (n.d.) Reporting the value of acquired intangible assets, http://www.buildingipvalue.com/05_SF/364_368.htm; PricewaterhouseCoopers, London

FASB New Approach for Goodwill Measurement

According to the Casabona (2001), the Financial accounting Standards Board issued SFAS No. 142 in reaction to increased merger and acquisition activity to promote international harmonization and to address the perceived flaws in the existing generally accepted accounting principles.One of the major flaws of ABP Opinion No. 17 was that the amortization of goodwill decreased reported income and diluted earnings per share (Casabona, 2001). SFAS No. 142 changed the measurement of goodwill and took a very different approach to the way goodwill and other intangible assets were accounted for after being recognized on the company's balance sheet. Unlike the APB No. 17, this Statement does not consider goodwill as wasting assets.

Instead, it considers that goodwill thathas indefinite useful life should not be amortized but should be tested annually for impairment (FASB, 2001b, para.18). Intangible assets that have finite useful lives should continue to be amortized over their useful lives without a mandatory arbitrary ceiling (FASB, 2001b, para.16). Because goodwill is not allowed be amortized there may be more volatility in reported income under SFASNo. 142 than there was under APB No. 17 (Anonymous, 2001). Similarly, Casabona (2001) noted that the elimination of goodwill amortization would result in more frequent write-downs, but also in inflated reported earnings and other potential earnings management techniques.

Testing Goodwill for Impairment

SFAS No. 142 provides specific guidance concerning the determination and measurement of goodwill impairment. This Statement established a two-step process that organizations should use to perform their annual goodwill impairment test. The Statement requires the impairment test of goodwill to be performed at the level of the reporting unit. A reporting unit is defined as an operating segment or one level below an operating segment, which is referredto as a component (FASB, 2001b, para.30).SFAS No. 142 alsorequires business entities to use quantitative factors to perform the two-step goodwill impairment test. The first step of the goodwill impairment test used to identify potential impairment is to compare the fair value of a reporting unit with its carrying amount, including goodwill.If the fair value of a reporting unit exceeds its carrying amount, no goodwill impairment exists.Therefore, it is not necessary to perform the second step of the impairment test. If on the contrary, the carrying amount of a reporting unit exceeds its fair value, it is necessary to perform the second step of the goodwillimpairment test to measure the amount of impairment loss, if any (FASB, 2001b, para.19).The second step of the goodwill impairment test is to compare the implied fair value of reporting unit's goodwill with the carrying amount of that goodwill. The Statement provides guidance to determine the implied fair value of the goodwill. If the carrying amount of reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss should be recognized in an amount equal to that excess. The impairment loss recognized cannot exceed the carrying amount of the goodwill. After the recognition of the impairment loss, an adjustment should be made to the carrying amount of the goodwill and no subsequent reversal will be allowed after the measurement process is completed (FASB, 2001b, para.20). SFAS No. 142, *Goodwill and Other Intangible Assets* also provided specific guidance on when goodwill should be tested for impairment. The Statement requires goodwill of a reporting unit to be tested for impairment on an annual basis and between annual tests in certain circumstances. The annual goodwill impairmenttest may be performed any time during the fiscal year as long as the test is performed at the same time every year. Different reporting units may be tested for impairment at different times (para.26). The Statement provides a list of circumstances or events if occurred in a reporting unit should result in an impairment test at this unit. Examples of such events or circumstances include:

- A significant adverse change in legal factors or in the business climate
- A n adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
- A more-likely-than-not expectation that a reporting unit or a significant portion of areporting unit will be sold or otherwise disposed of
- The testing for recoverability under Statement 121 of a significant asset group within areporting unit
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that isa component of a reporting unit

If any of these circumstances or events occurs, an impairment test should be performed at the reporting unit between annual tests to determine if the fair value of goodwill is less than the carrying amount (para.28). Moreover, SFAS No. 142 requires that goodwill be tested for impairment between annual tests after a portion of goodwill has been allocated to a business to be disposed of.

While the Statement requires performing the two-step goodwill impairment test at the reporting unit level, identifying the reporting unit constitutes a challenge for businesses. Although the FASB provides broad guidance to implement the impairment process, businesseshave struggled todefine the most appropriate reporting units and select the most favorable alternative to allocate the goodwill. The choice of reporting units and goodwill allocation may significantlyaffect the amount of goodwill impairment that companies will write off.In addition, business entities complain that the costs of performing step 2 of the goodwill impairment test is very high. As the convergence effort of the U.S. GAAP with International

Financial Reporting Standards (IFRS) is moving forward, it is important to look at how the International Accounting Standards Board (IASB) treats Goodwill.

IASB Treatment of Goodwill

Like SFAS No. 142, IAS 36, *Impairment of Assets* requires goodwill to be tested for impairment. Under IAS 36, goodwill is required to be tested at a level that reflects the way an entity manages its operations and with which the goodwill would naturally be associated (IASB, 1998, para.82). The company should recognize any impairment loss measured during the test (IASB, 1998, para.88). If the unit is a cash-generating unit to which goodwill has been allocated it is required to be tested for impairment annually.In addition, it must be tested whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit would be considered not impaired. However, if the carrying amount of the unit exceeds the recoverable amount of the unit, the entity should recognize the impairment loss (para.90).Contrary to IASB, FASB requires an entity to compare the fair market value of goodwill to the carrying value in order to determine the likelihood that an impairment exists.

In 2004, the International Accounting Standards Board (IASB) issued International Financial Reporting Standards (IFRS) 3, *Business Combinations* and revised International Accounting Standards (IAS) 38, *Intangible Assets*. These Statements provided a major change in the accounting treatment of goodwill after many years (Jerman&Manzin, 2008). The new IASB accounting rulesrequire business combinations to be accounted by using the purchase method. *IAS 38* does not recognize internally generated goodwill as an asset becausethe entity cannot identify and measure it reliably at cost (IASB, 2004, para. 49). It also requires goodwill not tobe amortized but to be tested for annual impairment. This change put the IFRS more in convergence with the U.S. GAAP. IASB requires that goodwill be recognized as the difference between the cost of the acquisition over the acquirer's interest in the net fair value of the identifiable assets, liabilities, and contingent liabilities. IAS 38 defines the fair value of an assetas "the amount for which that asset could be exchangedbetween knowledgeable, willing parties in an arm's length transaction."Unlike FASB, theIASB requires only one step in the goodwill impairment test and the entity should calculate the impairment write-down (Jerman & Manzin, 2008).

Goodwill Controversies

The valuation of goodwill in a business combination and the measurement after acquisition make goodwill a very controversial topic. The complexities involved in the measurement of goodwill and the elimination of goodwill amortization to replace it by impairment test, have an impact on the carrying value of goodwill on the balance sheet. As a result, total assets may go up and there may be volatility in income, and earnings managementmay occur. In fact, SFAS No. 142 states, “Because goodwill and some intangible assets will no longer be amortized, thereported amounts of goodwill and intangible assets (as well as total assets) will not decrease atthe same time and in the same manner as under previous standards. There may be morevolatility in reported income than under previous standards because impairment losses are likelyto occur irregularly and in varying amounts” (FASB, 2001b,Summary). Similarly, Cole and White (2003) noted that if there is no amortization, expenses will go down and earnings will go up. In addition, the goodwill impairment test is very complicated and costly. There are two methods available for valuation of goodwill, the equity value and the enterprise value methods. These two methods result in two different amounts. This issue creates a controversy among analysts and researchers. In reviewing a company's procedures for the annual impairment test, it is critical that consistent valuation principles and templates be applied whenever financial information is released (Cole & White, 2003).Many public and nonpublic companies complain about the high costs of performing the second impairment test.

Like goodwill, negative goodwill is also a source of controversies. Negative goodwill results from a bargain purchase and is required to berecognized by the acquirer in the income statement asa gain on the acquisition date (FASB, 2001a, para.36). Gittes (1978) indicated that negative goodwill arises when a company fails to produce sufficient earnings to sustain a value on the business as a whole, equal to the value of its separable resources and property rights or when investors are pessimistic about a company’s prospects for earnings. According to Ketz (2005), the SFAS No. 142 requires companies with negative goodwill to reduce the balance of long-term assets proportionally and transfer the remaining residual to extraordinary gains on the income statement. McDonnell (2004) noted that IASB has banished the term negative goodwill to replace it by “excess of acquirer’s interest in the net fair value of acquiree’s assets, liabilities, and contingent liabilities over cost.” Like the U.S GAAP, IFRS 3 requires any negative goodwill left after reassessment of the purchase to be recognized immediately in the income statement.

Ketz noted that negative goodwill has always been an issue for standard-setters because it is hard to sort out. According to Comiskey, Clark, and Mulford (2010), for decades, accountants have struggled with how to account for the excess of the value ofacquired net assets over the price paid for the acquisition of another firm. Conceptually, negative goodwill does not make sense. In efficient markets, there are few bargains.So accountants approach these situations from the perspective that valuations of the assets are probablyoverstated (Morris, 2004).

New Rules for Testing Goodwill Impairment

The complexities and controversies of the accounting treatment of goodwill are the major reasons why FASB is constantly changing the rules. The issuance of the SFAS no. 142, *Goodwill and Other Intangible Assets*to provide guidance about how goodwill should be accounted for after acquisition did not resolve the complexities, controversies, and concerns. A new issue arose concerning when to perform step 2 of the goodwill impairment test for reporting units with zero or negative carrying amounts. In December 2010, FASB issued AccountingStandards Update (ASU) 2010-28 to address questions about entities with reporting units with zero or negative carrying amounts. Some entities argued that their goodwill passed Step 1 of the test, there is no reason to performstep 2 although there are factors indicating that goodwill may be impaired because the fair value of their reporting unit will generally be greater than zero. This Accounting Update mandates that an entity with reporting units having carrying amounts that are zero or negative assess the likelihood that the reporting units' goodwill is impaired. If the entity determines that it is more likely than not that the goodwill of one or more of its reporting units is impaired, the entity is required to perform Step 2 of the goodwill impairment test for those reporting unit(s). Any goodwill impairment that resulted fromthe amendments should be recorded as a cumulative-effect adjustment to beginning retained earnings in the period of adoption. However, goodwill impairments subsequent of the amendments should be included in earnings as required by Section 350-20-35 (FABS, 2010, para.2). FASB acknowledges that this impairment model is different from that of the IFRS, which uses a single-step goodwill impairment test.

Despite the changes made by FASB to the accounting treatment of goodwill in ASU 2010-28, the complexities persist. Corporate managers and financial statement preparers still have concerns about the goodwill impairment test. The Financial Accounting Standards Board received complaints from preparers of nonpublic entity financial statements about the costs and complexity of performing the first step of the goodwill impairment tests required under Topic 350, *Intangibles—Goodwill and Other*. Those preparers suggested that the Board allow an entity to use a qualitative approach for testing goodwill for impairment. In an objective to simplify the rules for testing goodwill for impairment, the Board issued an Exposure Draft on April 22, 2011. This proposed accounting Standards Update would permit an entity to first assess qualitative factors to determine the likelihood that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test required under Topic 350. This Exposure Draft only provides guidance on how to test goodwill qualitatively to determine if the two-step test required under previous standards is necessary. The intent of this ASU was to reduce complexities and costs for nonpublic and public entities in preparing their financial statements (FASB, 2011, para.2). FASB acknowledges that nonpublic entities and small public companies incur greater costs relative to their accounting department budgets compared with large public entities because they do not have many internal resources that are qualified to determine the fair value of a reporting unit. Using qualitative factors to determine the likelihood of goodwill impairment is an alternative approach FASB offers to reduce costs for nonpublic and public entities (FASB, 2011, para.2). The Board allows an entity the discretion to bypass the qualitative assessment and proceed directly to performing the first step of the two-step impairment test. However, FASB suggested that an entity could resume performing the qualitative assessment in any subsequent periodunder this ASU.

Before adopting the ASU, the FASB received 89 comment letters from different sectors, particularly in the accounting industry. The respondents expressed their concerns, oppositions, and made some recommendations to the FASB and the Board analyzed the recommendations in order to deliberate on the proposal. Manyrespondents suggested that the Board further reduces costs to preparers if it proposed amendments to the second step of the two-step goodwill impairment test, which provides guidance for measuring an impairment loss because it is more complex and costly. However, the Board decided not to make any changes in step 2 of the goodwill impairment test. Many entities such Goldman Sachs (Comment Letter # 28) and PricewaterhouseCoopers supported the FASB's approach in the Exposure Draft. However, some other entities such as the American Appraisals Associates, Inc. (CL #23) and Deloitte & Touche, LLP (CL # 37) suggested that using qualitative factors will provide no cost savings or reduce complexity to the entity testing its reporting units because if the reporting unit fails the qualitative test, step 1 must be performed. On August 10, 2011, FASB approved the new Accounting Standards Update,which allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test.However, many concerns and recommendations about the treatment of goodwill still need to be addressed and many questions remain unanswered.

Conclusion

The accounting treatment of goodwill has evolved significantly throughout history. From the Accounting research Bulletins (ARBs) to the FASB, there have been many changes. Ding et al. identified four different approaches of accounting for goodwill in the history United States generally accepted accounting principles (GAAP). This qualitative studyfound that the changes in the accounting treatment of goodwill arise for many reasons such as the emergence of Mergers, and acquisitions, the increased importance of goodwill on the balance sheet of business corporations, the complexities created by the accounting rules, and the controversies over the accounting rules. Since the inception of the Financial Accounting Standards Board (FASB), the accounting treatment of goodwill has been modified many times from APB No. 16 & 17 to SFAS No. 141, 141R, and 142. Goodwill passed from being a wasting asset to be amortized over an arbitrary useful life of 40 years to an asset with indefinite useful life that must be tested for impairment. Despite the changes made in the treatment of goodwill over time, the complexities, controversies, and concerns persist. The Accounting Standards Update 2010-28 issued in December 2010 has not resolvedthe issues faced by nonpublic and public entities in testing goodwill for impairment. The Accounting Standards Update approved by FAB in August 2011 intended to reduce the complexity and costs of the goodwill impairment test. It would permit an entity to use qualitative factors to assess the likelihood that a goodwill impairment exists as a basis to determine if it is necessary to perform step 1 of the two-step impairment test. However, many entities still believe that these changes will not fulfill the Board's intended purpose. They still have many concerns and unanswered questions. It is not surprising that the accounting treatment for goodwill will continue to change as long as the rules continue to be complex and the step 2 of the impairment test continues to be so costly. FASB probably needs a different impairment model. For example, eliminating one of the two steps of the goodwill impairment test would reduce the complexity and costs associated with step 2 and at the same time eliminate some differences that exist between the IFRS and the U. S. GAAP.

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