# ACCOUNTING FOR GOODWILL: STILL CRAZY AFTER ALL THESE YEARS

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**Abstract**

For more than fifty years, goodwill has captured the fascination and frustration of accounting theorists. This analysis examines the changes in treatment of goodwill from the sixties to the present. Its purpose is to gain further insight into one of the most interesting puzzles in accounting theory.

## INTRODUCTION

Over the years, goodwill has been a source of fascination for many accountants and frustration for others. Intangibles by their nature present interesting puzzles for accounting theorists. Goodwill may be the most intriguing accounting theory puzzle of them all. The analysis that follows is a brief history of goodwill from the sixties to present times. Its purpose is to gain further insight into the complexity of this asset.

## GOODWILL DEFINED

When asked to define purchased goodwill in a business combination, most accountants respond by describing how to compute goodwill, which is the excess of the purchase price over the fair value of net assets. This definition, though accurate, begs for elaboration, something that would explain why a company would purchase another company for more than the fair value of its net assets. Reputation, customer loyalty, and longevity of operation are descriptions often used to describe goodwill. John Courtis (1983) compiled a list of 91 definitions of goodwill. With an abundance of subjective descriptors to choose from, settling on one common definition for goodwill has yet to occur.

Catlett and Olson (1968) compiled a summary of characteristics that distinguish goodwill from other elements of value in *Accounting for Goodwill* (Accounting Research Study 10):

1. The value of goodwill has no reliable or predictable relationship to costs that may have been incurred in its creation.
2. Individual intangible factors that may contribute to goodwill cannot be valued.
3. Goodwill attaches only to a business as a whole.
4. The value of goodwill may, and does, fluctuate suddenly and widely because of the innumerable favors that influence that value.
5. Goodwill is not utilized or consumed in the production of earnings.
6. Goodwill appears to be an element of value that runs directly to the investor or owner in a business enterprise (Catlett and Olson, pp. 20-21).

This summary is useful as a foundation for analyzing accounting for goodwill.

## ACCOUNTING TREATMENT

For many years, Accounting Research Bulletin 24 (ARB 24, 1944) was the authoritative pronouncement for the treatment for purchased goodwill. The excess of purchase price over the net assets of the transaction gave rise to an intangible asset, which could be 1) amortized, 2) immediately written off to either capital or earned surplus, or 3) retained at its cost until the goodwill became worthless (ARS 10, p. 42). Accounting Research Bulletin 43 prohibited the immediate lump sum write-offs. Accounting Principles Board (APB) Opinion 9 required any large write-off of goodwill to be reported as an extraordinary charge to income (ARS 10, p. 43).

In 1968, Catlett and Olson authored a research study, *Accounting for Goodwill* for the American Institute of Certified Public Accountants (ARS 10). They based their analysis on the notion that the value of goodwill pertains to the stockholders and is indeed an advance expenditure on their behalf in anticipation of future earnings (p. 90). Their approach led them to reject amortization of goodwill as an acceptable accounting treatment. In their analysis, they noted the following three characteristics of goodwill that focus on the lifespan of goodwill:

1. Goodwill is a value that attaches only to a business as a whole. There is no specific existence term, as there is for property rights.
2. The value of goodwill fluctuates suddenly and widely because of numerous factors—factors that affect earning power or investor opinion about earning power—which influence the value.
3. Goodwill value is not consumed or used in production of earnings, as are the separable resources and property right of a business. Rather, goodwill is the result of earnings or the expectation of them, and its value fluctuates as

> earnings expectations vary. Changes in the value of goodwill cannot be associated with the revenue of any period nor can they be assigned to a period on a rational systematic basis (p. 85).

They argued that a preferable accounting treatment for goodwill would be 1) an immediate write-off through the income statement, or 2) a reduction of stockholders' equity (a separate item after retained earnings, similar to other comprehensive income items) (p.92).

Catlett and Olson concluded that goodwill could not reasonably be evaluated in terms of either an unlimited life or some measure of a limited life. In their view, amortization is improper, since amortization implies an asset is consumed (or expensed) in achieving those earnings. (p. 85). The members of the Project Advisory Committee disagreed with Catlett and Olson's recommendations. They viewed goodwill as an asset (which inherently has a future benefit) and should not be written off at the time of purchase (p. 151).

ARS 10 did not produce a significant change in the accounting treatment of goodwill. The only change came two years later when Accounting Principles Board (APB) Opinion 17 (1970) established a maximum amortization period of 40 years.

Thirty years later, the Financial Accounting Standards Board significantly changed the approach on accounting for goodwill with the issuance of FASB 142 Goodwill and Other Intangible Assets (2001). In its September 1999 Exposure Draft, the Board proposed limiting amortization of goodwill to a maximum period of 20 years (p. 33). In February 2001, the Board issued a revised Exposure Draft, reversing its position 180 degrees and proposed replacing goodwill amortization with impairment testing (p. 34). Schroeder, Clark, and Cathey (2017) summarized the impairment process:

> Under the provisions of *SFAS No. 142*, the test for goodwill impairment is a two-step process:

1. Compare the fair value of the reporting unit to its carrying value. In the event fair value exceeds carrying value, no further testing is required. However, if the carrying value of the reporting unit exceeds its fair value, step 2 is required.
2. Calculate the implied fair value of goodwill by measuring the fair value of the net assets other than goodwill and subtracting this amount from the fair value of the reporting unit (p. 318).

The basis for the *FASB 142* Board's conclusions are stated in the Appendix B:

> As explained in Statement 141, the Board concluded that goodwill meets the criteria for recognition of an asset and therefore should not be written off at the date of acquisition. In discussing whether goodwill should be written off immediately subsequent to its initial recognition, the Board noted that it would be difficult to explain why goodwill is written off immediately after having just been recognized as an asset. If goodwill had been worthless on the date of acquisition, it would not have met the assets definition and would not have been recognized. However, if goodwill had value initially, virtually no event other than a catastrophe could subsequently occur in which it instantaneously became worthless (FASB 142, Append. B69).

> The Board acknowledged that achieving an acceptable level of reliability in the form of representational faithfulness was one of the primary challenges it faced in deliberating the accounting of goodwill. The useful life of goodwill and the pattern in which it diminishes are both difficult to predict, yet its amortization depends on such predictions. As a result, the Board acknowledged that the amount amortized in any given period can be described as only a rough estimate of the decrease in goodwill during that period (FASB 142, APPEN. B75).

Therefore, it appears that the FASB 142 Board and Catlett and Olson agreed that amortization of goodwill was not the appropriate accounting treatment. The Board disagreed with Catlett and Olson's view of immediate write-off, and chose to treat goodwill, as an asset and that asset will be reviewed annually for impairment.

FASB 142 remained unchanged for ten years. Displeasure from the business community focused on the costs associated with annual impairment testing. Determining fair value was a labor-intensive process and often required the hiring of outside consultants. The FASB responded by issuing FASB Accounting Standards Update No. 2011-08 Testing Goodwill for Impairment (2011), allowing the following option:

> An entity may first assess qualitative factors, as described in paragraphs 350-20-35-3A through 35-3G, to determine whether it is necessary to perform the two-step goodwill-impairment test discussed in paragraphs 350-20-35-4 through 35-19. If determined to be necessary, the two-step impairment test shall be used to identify potential

> goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (p. 5).

The next modification to FASB 142 was FASB Accounting Standards Update No. 2014-02, *Accounting for Goodwill, a consensus of the Private Company Council (2014),* which gave private companies the option of amortizing goodwill over 10 years. This approach is contrary to the position taken in FASB 142, which replaced goodwill amortization with impairment testing. It appears that the form of ownership (public or private) determines the accounting treatment of goodwill. There is little in the Standard that addresses this issue. It may be that the Board simply responded to private company executives and created a 10-year amortization approach similar to IFRS for SMEs (Small to Medium Enterprises).

The most recent change to goodwill accounting comes from FASB Accounting Standards Update No. 2017-04 that simplifies the test for Goodwill Impairment (2017). A summary follows:

> The amendments in this Update modify the concept of impairment from the condition that exists when the carrying amount of goodwill exceeds its implied fair value to the condition that exists when that exists when the carrying amount of a reporting unit exceeds its fair value. An entity no longer will determine goodwill impairment by calculating the implied fair value of goodwill by assigning the fair value of a reporting unit to all of its assets and liabilities as if that reporting unit had been acquired in a business combination. Because these amendments eliminate Step 2 from the goodwill impairment test, they should reduce the cost and complexity of evaluating goodwill for impairment (p. 3).

## CONCLUSIONS

The analysis above shows that there is plenty of intrigue surrounding the accounting for goodwill. First, there seems to be an elusive quality about goodwill causing difficulty in arriving at a common definition that describes it. Second, standard setters, along with many in the business community, have rejected the notion that goodwill is not an asset and should be written off immediately. Instead, they believe goodwill to be an asset, implying a future benefit. Finally, standard setters have abandoned amortization in favor of an impairment approach, and then later gave private companies the option to amortize goodwill over ten years. Meanwhile, the business community continues to pressure standard setters to streamline the impairment process. Thus, it would appear that with all that has been written about goodwill, there is plenty of room left for more.

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