TREATMENT OF GOODWILL IN ACCOUNTING

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GOODWILL is usually only recorded in an accounting system when a company purchases an unincorporated business or acquires a subsidiary or associated undertaking and prepares consolidated accounts. It is an item whose accounting treatment produces both conceptual and practical problems, with remarkable implications on the true and fair view. As on June 30, 2001, FASB changed the rules for the mergers and acquisitions game. Companies no longer can use the pooling-of-interests accounting method for business combinations. Nor will they account for mergers on their financial statements under the traditional purchase method, which required them to amortize goodwill assets over a specific time period. Instead purchased goodwill will remain on the balance sheet as an asset subject to impairment reviews. FASB's new standards, Statement no. 141, Accounting for Business Combinations, and Statement no. 142, Accounting for Goodwill and Intangible Assets, are a radical change, and now management accountants, auditors and financial executives must understand and work with a very different accounting process. Some believe FASB eliminated amortization to make purchase accounting techniques more appealing to corporate America. Traditional purchase accounting required companies to amortize 'purchased' goodwill on a periodic basis, for as long as 40 years. Now companies will be able to make acquisitions without being forced to take large periodic earnings write-downs, which some corporate executives view as an unnecessary drag on earnings. The elimination of pooling is one of the most significant and drastic modifications in accounting methodology in many years. Business combinations are important, and so is how they are treated in financial statements. Analysts will have to understand the impact of the two new FASB standards, and companies and their auditors will have to learn how to implement them.

Introduction

The Financial Accounting Standards Board *(FASB)*, the governing body responsible for establishing the standards of financial accounting and reporting, recently enacted two statements that overhauled the treatment of goodwill on the balance sheet and the accounting for business combinations. The new rules do away with goodwill amortization and the pooling-of-interests method of accounting for business combination.

Under the proposed modification, pooling-of-interest accounting treatment would still likely to be eliminated, but the goodwill generated in a purchase accession transaction would not be amortized earnings. Rather goodwill would be recorded as a permanent asset and would be reviewed for impairment and expenses against earnings only in the periods in which its recorded value exceeded its fair market value. It is important to note that apparently the non-amortization approach would apply only to goodwill, and that various other assets categories would remain subject to potential write-ups and post-acquisition amortization / depreciation in connection with a purchase acquisition transaction.

The FASB's decision on goodwill amortization is in direct response to the significant input which the FASB received from the investment and high tech communities and others concerning its original proposal, as well as the results of recent company field visits which indicated that an impairment approach could be developed that would be operational. Under the new approach, goodwill would be reviewed for impairment at the lowest financial reporting unit or units that include the acquired business. The acquirer would be required to determine the value of the reporting unit and the value of the recognized net assets excluding goodwill of the unit. The

difference between those amounts (namely, the implied value of the goodwill) would then be compared to the carrying amount of the goodwill, and if the carrying amount of the goodwill was greater than its fair market value an impairment loss would be recorded in the company's income statement. Impairment reviews would be performed initially based upon the significance of the level of goodwill to any particular reporting unit. Subsequent reviews would only be required "upon the occurrence of events indicating that goodwill of the reporting unit might be impaired".

Definition of Goodwill

The rule, established by the Financial Accounting Standards Board, is called FAS 142 and modifies the treatment of goodwill. By implementing the new rule, many companies will acknowledge in their first-quarter earnings just how much they overpaid for recent acquisitions, or more precisely, that some of these acquired assets will generate less cash than expected.

Goodwill perhaps is best defined with an example. Say a company pays $100 million to buy Company X, which has tangible assets – cash and equipment – worth only $40 million. The other $60-million of the purchase price is allocated to goodwill, or the value of the intangible assets, such as the Company X-brand name, intellectual property and workforce. According to some analysts, at the height of the tech boom, it was common for more than half of an acquisition price to the goodwill, because most of the purchased companies had little in the way of tangible assets. Under the old rules, companies would often have had to take that $60 million and diminish, or write down, its value on the balance sheet over several years. But that process, called amortization, diluted quarterly and annual earnings. If a company writes off $60 million over 10 years, it would be as $6 million hit to earnings each year.

In the 1880's, the first definition reflected goodwill as the difference between the purchase price and the book value of an acquired company's assets. Goodwill definition's has evolved since that time and may be defined in two different manners today: The residuum and the excess profits approaches (Johnson, 1993).

In the residuum approach, goodwill is defined as the difference between the price and the fair market value of an acquired company's assets. Goodwill is a leftover amount that cannot be identified, after a thorough investigation, as any other tangible or intangible assets. This is very similar to the nineteenth century definition. Both definitions imply that goodwill is the "leftover amount."

In the excess profits approach, goodwill is the difference between the combined company's profits over normal earnings for a similar business. Under this definition, the present value of the projected future excess earnings is determined and recorded as goodwill. This concept is very difficult to measure since future earnings have no certainty.

One characteristics of goodwill that has emerged over the past century is that it is inseparable from the business. It *can not* be sold without selling the business that is associated with it. If you can sell what you are calling goodwill, then it is something other than goodwill. It may be contract rights, a client list, distribution channels, or any number of other things and should be *labeled* as such, instead of lumped into the goodwill account. Goodwill can be *raised* in two different ways: (i) It can be internally generated or (ii) it can be acquired as part of the acquisition of another company. Both types of goodwill have been recorded in the past. However, only acquired goodwill is currently allowed to be recorded.

Accounting Treatment of Goodwill

The three qualitative characteristics most directly concerned with goodwill are reliability, prudence and consistency. The treatment of goodwill has changed over the years. The four methods of accounting for goodwill are discussed in the following manners (*http://home.att.net/~s-prasad/GW.htm*):

Write-off

Under this method, goodwill is immediately written off against an account in the stockholder's equity section, generally retained earnings. Advocates of this method argue that goodwill is not measurable and has no true future value. Thus, it should be written off against stockholder's equity.

Another rationale for this method is that overpayment for the assets of an acquired company *represents* the expectation of superior future earnings. Since these earnings eventually end up in the stockholder's equity, they can be offset against the excess acquisition payment. Although there are some good arguments for write-off method, it appears that it was used because it was the easiest and most widely used and not because it was conceptually correct.

Capitalization

This approach's proponents argue that if goodwill is as important as asset as many believe, it belongs to the balance sheet. One problem with capitalization of goodwill is determining the proper amount to capitalize. Current practice follows the residuum approach. One way of correcting the misuse of goodwill is through the hidden assets approach, Under this approach, the excess purchase price that companies pay over fair market value of the assets is for assets that are hidden from the balance sheet, then amortized over their useful life. If they were, goodwill account would probably be much smaller than in current practice and financial statements would probably be more useful.

Non-amortization

Capitalization of goodwill without amortization allows the most advantageous financial reporting figures. A company gets to record *an assets* instead of a decrease in stockholder's equity and net income is not periodically reduced. However, it probably would result in more abuse than any other method. The rationale for non-amortization is premised on the notion that goodwill does not decrease in value. High managerial ability, good name and reputation, and excellent staff generally do not decrease in value but they increase in value. Goodwill could be viewed as an investment and should stay on the balance sheet unamortized. But, without amortization, abuse may occur, and the goodwill account will lose what limited significance it has now.

Amortization

Amortization enables companies to match the cost of intangible assets over the period deemed to benefit from their acquisition. Main arguments for amortization are the abuse of non-amortization and the unreliability of earnings without some attempt to recognize the impact. When amortization became is required, the period for write-off becomes the focus. If the life of the assets is non determinable, which is normally the case with goodwill, amortization over a maximum of twenty years should be used. This lengthy period was set to allow a minimum impact to the net income (McClenahen, 2001).

Pooling is Eliminated

In July 2001, the Financial Accounting Standards Board *(FASB)* released SFAS 141, *Business Combinations*, and SFAS 142, Goodwill and Other Intangible Assets. These standards are the result of a long FASB project that began in 1996 due to the increase in M&A activity that brought great focus to the differences between purchase and pooling accounting in conjunction with business combinations.

All business combinations will be treated as purchases. Because pooling placed restrictions on deal structure, post-deal rationalizations and compensation structures, its end will have the following impact upon future deals:

- *Flexibility to sell non-core assets.* Pooling restrictions did not allow for the disposal of non-core acquired assets.
- *Increased use of cash in deals.* "Because pooling forbade the use of cash consideration, often the high bidder was the one who could pay in stock without suffering the effect of goodwill amortization," Cooper explains. "Since the choice of cash versus stock no longer affects the accounting result, the advantages of being a cash bidder may now tip the scales."
- *Treasury stock repurchases may become more popular.* Pooling restricted the reacquisition of Treasury stock. Now companies are free to use stock repurchasing as a means of maintaining earnings per share especially when management believes the shares are undervalued.

- *Greater flexibility in structuring compensation programs.* "Pooling placed restrictions on a company's ability to cash out, alter or grant new equity awards and that will now cease to be relevant in future transactions," says Yeftich.
- *More contingent consideration.* "Pooling forbade earn-out structures," Cooper explains, "so now that pooling is not an alternative, all bidders are on equal footing to offer earn-outs as a potential deal provision. For some time, we've been seeing bidders more inclined to take a 'prove-it-to-me stance' in the Valley anyway," he notes, "and now it's no longer a disadvantage because no one will be competing against a pooling bid."

Measurement of Purchased Goodwill

In determining the amount of purchased goodwill the purchaser needs to recognize all assets acquired, whether of a tangible or intangible nature. This might involve recognizing some intangible assets which, if internally generated by the purchaser, would not normally be recognized as assets because the absence of an exchange transaction usually prevents them from being measured reliably. Fair value is a measure of the worth of an asset at a specified time, and is utilized in this Standard as the amount which the purchaser attributes at the date of acquisition to the identifiable assets acquired. When making an assessment of the fair values to be attributed to individual assets, the purchaser may sometimes find that a number of such assets are combined into a related or composite group. Under these circumstances, it may be more appropriate to consider the fair value of the composite group rather than the aggregate of the fair values of the individual assets (*http://home.att.net/~s-prasad/GW.htm*).

The purchase consideration may include any one, or combination, of the following:

(i) Cash; and /or

(ii) Other monetary assets; and /or

(iii) Non-monetary assets; and /or

(iv) Liabilities undertaken.

When the purchase consideration includes cash and/or other monetary assets, its value is usually readily determinable. However, where the purchase consideration comprises (either partially or totally) non-monetary assets, its value will need to be ascertained by reference to the fair values of the non-monetary assets given.

Where the purchase consideration comprises shares or other securities of the purchaser and these securities are listed on an *Australian Stock Exchange*, the price at which they could be placed in the market will usually be an indication of their fair value. Where the securities issued are those of an unlisted entity, it may be necessary to make a valuation of those securities. It should not be assumed that the par value of securities reflects their fair value, as this rarely is the case.

Where an entity incurs cost that directly relate to the acquisition, these need to be included in the determination of the cost of acquisition. These costs would normally include legal fees, stamp duty and other government charges, and professional fees in the nature of feasibility tests and investigations preceding acquisition."To the extent that the cost of acquisition incurred by the entity exceeds the fair value of the identifiable net assets acquired but the difference does not constitute goodwill, such difference must be recognized immediately as an expense in the profit and loss account".

Effective Management

By one recent estimate, 70 percent of mergers and acquisition do not add to shareholder value – or actually subtract from it. And paying too much for an acquisition and underestimating the difficulty of integrating assets are merger phenomena that "aren't going away," says Stern Stewart's Pettit. "The new rules will put more focus on how effective management has been in translating the reasons behind doing a deal into results", " stresses KPMG'S Heckler.

"As goodwill will not longer the amortized, management will be challenged properly to identify and value all assets that will be consumed by the company in its earnings process, and those that do not, but provide for a

competitive advantage," says, Torres, " I believe the new (rules) will provide more information to financial statement users, more consistent earnings comparisons between companies, and strong post merger evaluation of a business combination."

The process of evaluating the performance of goodwill is technically known as testing for impairment. In practice, that means checking for a decline in value and then taking a write-off for those operations that Paul Munter, a Professor at the University of Miami's School of Business, describes as not doing "as well as you were expecting." Particularly if a company is trying to focus on its core earnings, says Munter encouragingly, a one-time, non-recurring write-off is "a lot easier to explain to analysts" than is an annual amortization charge against earnings spread over 30 or 40 years.

Indeed, Munter expects once the goodwill rules take effect a "bunch of companies" will "suddenly" take one-time write-offs for under performing acquired assets. Although those write-offs will somewhat decrease companies' current earnings, securities analysts and investors could well be favorably increased since, without the write-offs and amortization of goodwill, future earnings for the companies will be higher, says Munter.

Tax Treatment

Currently, IRC Reg. Sec. 1.167(a)-3 specifically prohibits the write off of "goodwill." Amortization is allowed on other intangible assets as long as the asset meets the following criteria established in Rev. Rul. 74-456: 1) A specific useful life can be determined and 2) the asset has a value separate and distinct from goodwill.

IRC Sec. 1060, resulting from TRA 86, requires both the seller and the buyer to use the residual method for measuring goodwill. Under this method, goodwill is computed as the difference between the purchase price and the fair market value of the "assets" of the acquired company. Obviously this is the same as the residuum method discussed earlier. The purchase price is to be allocated to assets in the following order: 1) Cash and items similar to cash, 2) marketable securities and similar items, 3) tangible and intangible assets excluding goodwill and going concern value, and 4) goodwill and going concern value. Going concern value resembles goodwill and is treated similarly.

The allocated purchase price must be reported to the IRS by both companies in their tax returns filed in the year of acquisition. Goodwill is considered as a capital asset. Therefore, the seller will want to allocate as much of the selling price to goodwill as possible. Even though current capital gains rates are the same as the regular corporate rates, this could change with future legislation. Also, capital gains created can be used to offset any previous capital loss carry forwards.

The buyer will want to allocate more of the selling price to non- goodwill assets because goodwill amortization is not tax deductible while depreciation and amortization of other assets is tax deductible. This "negotiated" goodwill will stand as the IRS value. Thus, the IRS has effectively forced the controversial goodwill determination on the buyers and sellers of the acquired companies. This makes it even more imperative for buyers to specifically identify any hidden assets they are acquiring at the time of purchase.

Recent court decisions have allowed depreciation for several intangible assets where separate and distinct values from the business could be established and limited useful lives existed. Newspaper subscription lists have proven separable in two instances. In Donrey v. U.S., separate existence was proven for the subscription list because it was used in determining advertising rates and in selling advertising. In Newark Morning Ledger Co. v. U.S., a separate fair market value was established for the subscription list by using the income approach. Life annuity tables were then implemented to determine the useful lives of the subscribers.

Customer lists have proven to be deductible in several cases including Manhattan Company of Virginia v. Commissioner, Panichi v. U.S. and ABCO Oil Corp. v. Commissioner. Customer lists are considered to have a separate existence as long as one of the individuals on the list continues as a customer for more than one year.

Deposit bases of banks have recently been allowed as intangible assets. In Citizens & Southern Corporation v. Commissioner, a depreciable intangible asset separate from goodwill was identified for the present value of the

future stream of income from the core deposits of the bank. The amount of annual amortization was the difference between the beginning and the ending present values.

A variety of contracts – location, employment, management and general business – have been held deductible as long as a specified life and separate existence has been established. Unlimited renewal options preclude the deduction. In Business Service Industries v. Commissioner, the location contracts acquired in a merger were used to obtain a bank loan. The bank's recognition of the separate existence of the contracts helped establish the tax basis for the depreciable intangible asset.

Tax incentives, which affect real cash flow, are usually reasons enough to allocate as much of the residual value as possible to intangible assets other than goodwill. The above cases show that certain intangible assets do have value and lives separate from the ongoing business.

One of the main such intangible assets is key personnel. However, this intangible generally cannot be recognized as an acquired asset for tax purposes. For example, in the electronics industry key employees play a big role in the success of a business. In acquisitions of these companies, substantial amounts are paid for key personnel. The ability to identify the amount paid for key personnel and list separately and amortize over an appropriate life, would hold significant advantages.

Conclusion

It summation, it has been brought out that the FASB has proposed a new accounting standard that will eliminate the use of the pooling of interests treatment in acquisitions and also end the amortization of all goodwill (Moehrle and Jennifer, 2001). Goodwill will remain on the balance sheet and be tested for impairment if certain trigger events occur. Companies that have made purchase acquisitions in the past will get a one time expected step-up in EPS. These changes could result in increased M&A activity since acquirers no longer have to consider the possible dilution from goodwill charges (McClenahen, 2001). This preposition appears to satisfy most of the constituents that opposed FASB's earlier proposals on business combinations, in particular those in the domains of technology and finance industries.

Analysts and other users of financial statements, as well as company management, noted that intangible assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many transactions. As a result, better information about intangible assets was needed. Financial statement users also indicated that they did not regard goodwill amortization expense as being useful information in analyzing investments.

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