Accounting Research Study No. 10 — "Accounting for Goodwill" — A Summary of Its Conclusions

By WILBUR S. DUNCAN, CPA

Accounting for goodwill has always been an intriguing problem but the submergence of goodwill in poolings of interests gives it an extra significance presently. Consequently, the AICPA study (ARS No. 10), "Accounting for Goodwill" is timely as is this review of it.

George Catlett and Norman Olson, in their research study "Accounting for Goodwill," have proposed solutions to one of the most difficult and most urgent problems in modern corporate reporting. Their proposed solutions are controversial, as may be expected of any proposed basic change, but they are based on a thoughtful, thorough study of the nature of goodwill and its significance in financial statements.

Businessmen universally recognize the importance of goodwill. They understand that these intangibles of management, labor skills, technical know-how, brand-names, marketing relationships, competitive position, etc., are vital, inseparable and unseparable so far as the business enterprise is concerned. They consider them valuable to the extent that they will supposedly produce future earnings at desirable levels. They place a value on these future earnings by paying a price for securities of the enterprise in excess of the underlying net tangible assets. These values create accounting problems, however, only when the business enterprise *itself* spends money to create or maintain goodwill or when it enters into merger transactions to acquire the existing goodwill of others.

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THE NATURE AND VALUE OF GOODWILL

Early in their study the authors inquire into the nature of goodwill. Recognizing that both tangible and intangible assets are essential to the operation of every business, they nevertheless find fundamental differences in the two. Tangible assets can usually be separated from the business whereas goodwill cannot. Tangible assets are usually in the process of being consumed in production (inventories, plant, equipment, etc.) or have value of their own apart from the business (cash, securities, receivables), whereas intangibles such as goodwill have an existence only insofar as investors view their capacity to generate earnings. At the conclusion of chapter 2, the authors summarize certain characteristics which generally distinguish goodwill from

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other elements of value in a business. Their summary of these characteristics follows:

1. *The value of goodwill has no reliable or predictable relationship to costs which may have been incurred in its creation.* Some goodwill values may be created by expenditures which the company absorbs as operating expenses; many favorable conditions and factors result without expenditures or efforts of a company. Some profit-directed activities create values not measurable and not subject to accountability.

2. *Individual intangible factors which may contribute to goodwill cannot be valued.* All of the various intangible factors which are favorable to a business as a whole contribute to the value of goodwill but none of them, individually, is susceptible to the type of measurement that can be applied to resources and property rights whose values exist apart from the business as a whole. Likewise, no valid bases exist for allocating costs to the intangible factors, and their values can be judged only in the aggregate in relation to a company's earning power.

3. *Goodwill attaches only to a business as a whole.* Goodwill does not exist as a value apart from other assets. It is an inseparable part of a business and cannot be sold separately from a business or from a clearly delineated segment of a business.

4. *The value of goodwill may, and does, fluctuate suddenly and widely because of the innumerable factors which influence that value.* Many factors affect both earning power and investor opinion about earning power. The value of goodwill does not have the general stability possessed by the value of most resources and property rights used to produce earnings.

5. *Goodwill is not utilized or consumed in the production of earnings.* Rather, goodwill is the result of earnings, or of the expectation of them, and its value is a measure of the expectations. Earnings are produced through the consumption or use of a company's individual resources and property rights—those elements of value which appear in a company's balance sheet —and through effective management in combination with intangible factors. As earnings increase, the expectation of enhanced future earnings may increase, and the value of goodwill increases. As earnings decline, the results reverse. Any decrease in the value of goodwill in a going business is not associated with revenue of the period or assignable to a period on any rational or systematic basis. Just as the several factors which contribute to goodwill cannot be individually valued, neither can a decrease in the value of the factors be measured and assigned to particular periods.

6. *Goodwill appears to be an element of value which runs directly to the investor or owner in a business enterprise.* Only investors or owners establish the value of a business taken as a whole and thereby of its goodwill.

BASIC OBJECTIVES AND CONCEPTS

One of the serious problems encountered in the study was determining the premises and concepts to be used as criteria. Since the accounting profession has not yet defined authoritatively the purposes or objectives of financial statements, the authors have set forth their own views of such objectives and have identified certain other premises and concepts necessary as a foundation for reasoning on the problem.

The authors' views as to financial statement objectives and accounting conventions and concepts will be accepted as rational by most accountants. In fact, the AICPA would be well advised to pursue these questions of basic objectives and concepts; so long as they remain undefined, solutions to individual problems will continue to be elusive and lack coherence. Readers may agree or disagree with the authors' views as to financial statement objectives, and they may agree or disagree with their reasoning on accounting for goodwill to meet these objectives, but they have stated their complete proposition. This in itself is unique in research studies.

Earnings data are most important and useful. Usefulness and *comparability* are described as fundamental objectives of financial statements. The primary purpose of accounting is to pro-

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vide public information which investors can use to make decisions as to buying, selling or retaining ownership interests in the business, and creditors can use as a basis for extending credit. Furthermore, the decisions of the investor and the creditor involve the process of choice, so the statements should provide a basis for comparing the performance of one business with others.

The primary purpose of business activity is seen as "earning a satisfactory return for the risks owners assume." The quality of a business and its management is therefore judged primarily on its success in generating earnings. This quality is important not only to the equity owners but also to creditors, employees and taxing authorities. For this reason, public information on earnings constitutes the most important and useful financial information concerning a business entity.

The authors then state that "regardless of the quality of investor judgment and the myriad factors which mold his opinions on stock values, the appraisal of a business enterprise's prospects for future profits (earning power) primarily govern, in the long run, the prices at which shares of stock in the business are traded." This market value of a business enterprise so determined by earnings, however, does not represent the sum of the current values which might be placed on the tangible assets (individual separable resources and property rights) which the business has devoted to achieving that earning power. It follows, therefore, that:

1. The total value of a business is determined by investors in the market, and
2. while financial statements do not purport to reflect such market values, the income statement should measure earning capacity and the balance sheet should provide significant information about the value of the separable resources and property rights committed to the business. The value of these tangible assets compared with market price of the stock provides a measure of the risk assumed or the premium paid by the investor for the right to future earnings.

Accounting Conventions Pertinent to Goodwill. Going beyond financial statement objectives, the study also refers to certain broad accounting conventions and concepts pertinent to the goodwill question. The "realization" principle of recognizing revenues has as its corollary the cost basis of carrying assets in the balance sheet. These conventions give rise to the central problem in accounting—proper matching of costs with revenues. In this connection, the study points out that, even though all costs must be assumed to contribute to earnings, *all costs are not deferred.* Generally costs deferred either (a) have reasonably clear periods of revenue benefits, or (b) represent separable assets which have value apart from the business. Many other costs relating to the future are charged to current income—product development, advertising, development of management and labor skills, etc. The only significant exception to these concepts has been the accounting for purchased goodwill.

ACCOUNTING FOR NONPURCHASED GOODWILL

A chapter is devoted to present practices of accounting for internally generated goodwill and the conclusion is that "neither the value of nonpurchased goodwill nor expenditures incurred to create goodwill should be capitalized and amortized against future earnings." It is conceded that certain current expenditures for product development, advertising and similar expenses do in fact benefit future periods, but there are insurmountable problems in identifying *which* expenses, the extent of the benefits or the periods over which they should be amortized.

The authors explore briefly the con-

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cept that total goodwill of the business enterprise might be recorded on the balance sheet and amortized to income. With respect to this proposition they conclude that it represents an "untenable position that the continually changing composite opinion of investors as related to the prospective earning power of a business should be capitalized by the business and amortized as a reduction of the earnings being evaluated. Such a procedure would introduce investor opinions of values into financial statements which are designed to furnish information which investors use in arriving at their opinions."

While the present practices of accounting for *nonpurchased* goodwill are considered sound and responsive to the purposes of financial statements, the present practices of accounting (or not accounting) for goodwill purchased in merger transactions present problems of serious proportions.

GOODWILL AND ACCOUNTING FOR MERGERS

Accounting for the merger of two business enterprises almost invariably involves the question of goodwill—unless the merger is treated as a pooling-of-interests, in which case there is really a "non-accounting" for goodwill.

In chapter 4 of the research study, the history and evolution of accounting for business combinations is traced. The past twenty years have seen a fantastic growth in business acquisitions and mergers, and a rapidly-accelerating deterioration in the "pooling-of-interests" method of accounting for stock exchanges. The pooling-of-interests concept arose just prior to 1950 as the logical treatment for a true economic merger of two substantial enterprises where neither could be considered to have "acquired" the other.

Pooling of interests, originally conceived as a permissive method having limited application, rapidly developed into a popular alternative to purchase accounting. Many factors contributed to this—the more stringent requirements on accounting for goodwill in a purchase, increased use of common stock in an inflationary economy, and the advantages of tax-free exchanges of stock. Under these pressures, the criteria originally specified for poolings of interest have virtually disappeared. The last remaining criterion—issue and retention of voting securities as the exchange medium—can be circumvented by purchasing and issuing treasury shares, by downstream mergers or by limiting sale of shares received over a two-year period.

The Heart of The Pooling Controversy. In recent years the problems of pooling accounting and the illogical answers they frequently produce have brought it under increasing criticism. The principal reason both for the popularity of pooling and for its problems is that it eliminates the need to account for goodwill and unrecorded tangible asset values. Pooling accounting effectively writes off these values against capital surplus without requiring a journal entry to do so.

At the heart of the pooling controversy is the question as to whether business combinations with stock differ in substance from those with cash. The authors have prepared a summary of the arguments on both sides of the question, and in studying these arguments they have considered Accounting Research Study No. 5 ("A Critical Study of Accounting for Business Combinations") by Arthur Wyatt published by the AICPA in June 1963. They reach the same conclusions as did Wyatt—that substantially all business combinations today are exchange transactions between companies of dis-

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proportionate size with a rather clearly discernible continuing entity, and that pooling of interests accounting is not appropriate for such exchange transactions. They further find no significant difference in substance between business combinations effected by stock and those effected by cash, and, absent any substantive difference in the nature of the transaction, they find no reason for differences in accounting. Their reasoning is best expressed in their own words:

> We conclude that the proper accounting for business combinations is to be found in the general concepts underlying purchase accounting rather than in those underlying pooling of interests accounting. The form of consideration most often results from negotiation and represents a preference of the stockholders; but this preference does not change the facts relating to the fair presentation of financial position or results of operations.
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> No justification exists for the argument that nothing has really happened to the assets and businesses of two companies when stock has been exchanged in a business combination—a contention which proponents of pooling of interests advance as support for combining existing asset, liability, and equity accounts. There are, in fact, changes. As examples, the assets of the continuing company increase; management organizations change, often to a considerable degree; the terms of liabilities and debt may change; and production, operations, and marketing policies may change greatly. Many of the changes are inherent in the conditions which motivated the business combination.
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> In business combinations effected by stock, the stockholders of the absorbed company switch their investment to a combined company, with the same effect as if they were to sell their stock and reinvest the proceeds in stock of another company. In either an exchange or sale of new stock, the total assets differ. The substance of a stock-for-stock combination is not a mere exchange of ownership shares, rather, new stockholders are brought into a company through issuing shares for the assets and business that the stockholders owned. Thus, the transaction transfers assets from one entity to another.
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> The evidence and realities indicate clearly that the shares issued in a business combination effected by stock should be accounted for in the same manner as shares issued for cash, plant, or any other property—at the fair value of the consideration given or the fair value of the assets received, whichever is more clearly indicated. When stock is issued for the business and assets of a going concern, the value of the business and assets will ordinarily be measured by the market price of the stock issued (when a market exists), modified for fluctuations resulting from investors' appraisal of advantages arising out of the combination. Regardless of the formulas managements use in setting the terms of a combination, values as established in the market are exchanged and must be considered in establishing those terms.
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> Income tax statutes do not establish sound accounting principles. The fact that an exchange transaction may be "tax-free" for income tax purposes should not control the accounting for financial statement purposes. Incidentally, the term "tax-free" as used for an exchange is a misnomer, since tax effects may arise later for both parties to the transaction.
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> The only significant difference between using stock and cash to effect a business combination is that cash represents a distribution of existing resources of the continuing entity and stock does not. This distinction appears to be of limited importance in determining the proper accounting for business combinations, since it is just as important to account for the value of stock issued as for the value of resources expended.

The authors concede that there may be a relatively few business combinations where the constituent companies are so similar in size and integration of management that neither can be termed the "survivor." Under these conditions they believe that the answer lies in a new basis of accountability for the assets of both companies.

THE COST OF PURCHASED GOODWILL

The study devotes a chapter to the method recommended for determining the cost of purchased goodwill—it is the amount by which the aggregate consideration paid exceeds the fair

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value of the net tangible assets received. In mergers involving the issue of shares, the amount of the consideration "should ordinarily be measured by the fair value of the stock issued, as determined at the date the agreement on final terms is reached. . . . Although the value of the consideration given may vary depending on the seller's preference as to form . . . market price does in fact represent the value of the consideration agreed on by the buyer and seller in the transaction and is the value for which an accounting must be made."

Once the price paid to acquire a business has been determined, the total must then be allocated (a) to the separable resources and property rights and (b) to goodwill. The study concludes that the economics of a merger are such that there must be accounting recognition of the fair value of tangible or separable intangible assets acquired. These fair values ordinarily would be factors in the price paid and recording such fair values is essential to proper measurement of future income. The balance of the purchase price would be allocated to goodwill. This conclusion is consistent with the concept that goodwill is the value of a business enterprise over and above the value of the separable resources and property rights required for its operation.

ACCOUNTING FOR PURCHASED GOODWILL

Having established the premise that substantially all business combinations, whether effected by stock or cash, result in the purchase of goodwill, chapter 8 of the study moves to the matter of accounting for the purchase. Present practices are summarized (including the "non-accounting" inherent in poolings), evaluated and found to be inconsistent with the objectives of financial statements.

Those who support the recording of purchased goodwill as an asset argue that "an expenditure has been made, a portion of it identified as goodwill, and accounting recognition of the goodwill value as an asset is appropriate." If, however, the function of a balance sheet is to report the separable resources and property rights committed to the business, what purpose does recording this asset serve? It is generally understood that a balance sheet does not purport to reflect the intangible values of the business. In any event the amount recorded represents only that part of goodwill attributable to the acquired business, and not the total for the combined enterprise. Furthermore, this amount almost immediately begins to lose identity and significance as the investors commence to create new goodwill values based on subsequent operations of the combined companies.

Amortization of Goodwill. Many of those who advocate recording of goodwill as an asset would also argue that it should be amortized by periodic charges to income. Presumably such amortization to income would be appropriate because (a) the goodwill has an estimated useful life or (b) it represents the cost of specific future earnings. However, unless the concept that goodwill actually has an estimated period of existence is valid, then amortization is arbitrary and thus potentially misleading. The study earlier specified three characteristics of goodwill which bear on this question:

1. Goodwill is a value which attaches only to a business as a whole; it has no specified term of existence as do certain property rights.
2. The value of goodwill may, and does, fluctuate suddenly and widely because of the innumerable factors—factors affecting earning power or investor opinion about earning power—which influence that value. Goodwill value may rise, fall, expire, and be recreated by those factors many times

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and in unpredictable ways during the life of a business.

3. Goodwill value is not consumed or used in the production of earnings as are the separable resources and property rights of a business. Rather, goodwill is the result of earnings or the expectation of them, and its value fluctuates as earnings and expectations of earnings 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 or systematic basis.

A careful consideration of these characteristics indicates that goodwill cannot reasonably be evaluated in terms of either an unlimited life or a measurable estimated limited life.

The study also finds amortization of goodwill inconsistent with the objectives of financial statements, because "a charge to income for goodwill. . . . reduces the usefulness of the income statement to the investor who uses that statement to appraise the value of the business. Measurements are impaired if the values being measured are allowed to affect the measuring device."

Contradiction in Accounting for Purchased and Nonpurchased Goodwill. Finally the argument is made that accounting should be consistent for all goodwill — whether purchased or internally generated. The present practice of writing off current expenditures for internally generated goodwill (as opposed to recording them as assets to be amortized) has general approval. The practical effect of, say, developing a new product is that tangible assets are expended and written off in order to obtain the intangible benefit of future earnings. *The stockholder has agreed to reduce the tangible asset value of his investment in return for future profits.* Does not the stockholder do the same thing when his company acquires another business for an amount exceeding the value of the tangible assets? In the one case the goodwill payments represent a variety of unidentifiable transactions over the life of the business. In the other case, a lump sum is identifiable with a specific entity acquired as a unit. The purposes and nature of the payments, however, are essentially the same.

With respect to present practices, the study concludes the practical arguments advanced for capitalizing purchased goodwill as an asset and amortizing it to income are not valid. Further, it concludes that present practices of accounting for internally generated goodwill are sound, and, since all goodwill has the same characteristics, there is no justification for significant differences in accounting for it.

Proper Accounting for Purchased Goodwill. The authors recognize, however, that the purchase of goodwill in a business combination is a significant fact and that it must be accounted for. They believe that the method most responsive to the objectives of financial statements is to reflect goodwill as a reduction in stockholders' equity, either as a direct write-off to surplus or as a continuing deduction from stockholders' equity in the balance sheet. They reason as follows:

Thus, amounts paid for goodwill in a business combination represent disbursements of a portion of a company's resources (or in a business combination effected by stock, a portion of the value of the stock issued) in anticipation of future earnings. The disbursement of resources reduces the stockholders' equity in a company's separable resources and property rights by a corresponding amount, and accounting for purchased goodwill as a reduction in stockholders' equity evidences that fact.

If goodwill is accounted for as a reduction in stockholders' equity, the balance sheet would provide, subject to the limitations of the cost basis, information regarding values of the separable resources

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and property rights of the continuing business—an objective of the balance sheet. That information would not be confused, as it would be by injecting the particular goodwill value of a segment of the business at a point in time—a value which no longer exists, perhaps, as a part of the overall goodwill value of the business. Similarly, the record of earnings of the business, an important yardstick which investors use in assessing the value of the business as a whole, would not be affected by amortization of that very value.

THE NEED FOR AN ANSWER

As might be expected in a problem as complex as goodwill, most of the members of the project advisory committee found the study to be controversial—as will most of its other readers. Importantly, however, none of them disagreed with the urgent need to deal with the weaknesses inherent in pooling-of-interests accounting.

George Catlett and Norman Olson have provided a rational, thoughtful inquiry into the nature of goodwill, and, based on their assumptions as to the objectives of financial statements, have proposed solutions to accounting for goodwill which they believe best meet these objectives. Their solutions are provocative, well-supported and deserving of study. The most controversial aspect undoubtedly will be the proposal to reflect purchased goodwill as a reduction of stockholders' equity. Strangely enough, many accountants who will throw their hands up in horror at such a suggestion, will nevertheless approve pooling accounting which accomplishes the same objective without even disclosing the amounts involved.

All are urged to read this research study carefully and objectively. As a minimum, it represents a solid beginning in the arduous process of finding logical answers to the problems of accounting for goodwill. It is clear, however, that those answers will not be found in historical literature, but rather in looking forward first to defining the purposes and objectives of financial statements and thereafter the goodwill treatment appropriate to these purposes and objectives. Most importantly, the accounting prescribed for goodwill must be logical and understandable to the business community—which means that it must accord with the economic realities of business combinations.

THE UNDERLYING MOTIVE FOR INFORMATION DISCLOSURE

There appear to be two divergent views on information disclosure. Some see it as an effort to achieve a higher price for a company's stock. Others see it as an effort to tell investors the essential facts about the company, its management, its finances, and its products. On the surface, it might seem that the first view is cynical and the second naive, and that the best practical approach lies somewhere between the two. But at the (New York Stock) Exchange we are convinced that the second view is actually the highly sophisticated one. We have observed that this is the approach used by the most reputable, most hard-nosed-and most successful-corporations in the country.

From "Information Disclosure: What and When?"
By Phillip L. West
Financial Executive, December 1968

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