

The Emerald Research Register for this journal is available at
www.emeraldinsight.com/researchregister



The current issue and full text archive of this journal is available at
www.emeraldinsight.com/1469-1930.htm

Accounting treatment of goodwill: yesterday, today and tomorrow

Problems and prospects in the international perspective

Accounting
treatment of
goodwill

131

A. Seetharaman, M. Balachandran and A.S. Saravanan
Faculty of Management, Multimedia University, Cyber Jaya, Malaysia

Keywords Goodwill accounting, International accounting, Standards

Abstract The issue of goodwill has been debated in many countries throughout the world. Despite numerous efforts and the existence of accounting standards and exposure drafts issued by various professional bodies internationally, there is yet to be a universally accepted accounting treatment for goodwill. The opinion on this subject differs and changes frequently. The dichotomy of having to preserve prescribed recognition criteria on the one hand and the need to report useful information on the other has led to the many controversial issues debated on the subject of goodwill. This study centres around the international accounting treatment of goodwill in the past, present and future. This study reviewed some of the issues that surrounded the accounting for goodwill where it was found that goodwill accounting had faced many problems. Besides problems, this project also looks into the prospect of the accounting for goodwill in the cyberspace era and emergence of the knowledge-based economy. This study confirms that controversy remains internationally with no solution in sight in the foreseeable future internationally.

Introduction

Among the major accounting problems yet to be solved, accounting for goodwill looks very special when compared to other priority items. First, it is the most controversial issue. Second, it is one of those rare intangibles that managers are trying to wheedle into the balance sheet in spite of accountants' best efforts. Thus the question that inevitably comes to mind is "Why are accountants so fearful of goodwill and more generally of all kinds of intangibles?" (Jean, 1990).

The *laissez-faire* attitude to goodwill accounting over the past five years has therefore encouraged companies to select the treatments which give the most favourable results. These abuses have been well documented and include (Woolf, 1990):

- Allocating low values to acquired assets and a correspondingly high value to goodwill; writing off goodwill against reserves and enjoying low future depreciation charges on acquired assets.
- Inflating goodwill still further with a provision for future rationalisation costs; writing off future revenue costs against the provision (rather than



Journal of Intellectual Capital
Vol. 5 No. 1,
pp. 131-152
© Emerald Group Publishing Limited
1469-1930
DOI 10.1108/14691930410512969

profits), and writing back to profit and loss account any part of the original provision now regarded as excessive.

- Obtaining the court's permission to write off goodwill against share premium account.
- Writing off goodwill against nothing at all, creating a negative "goodwill write-off reserve" which can linger indefinitely as a dangling debit, leaving other reserves and earnings intact.
- Writing off goodwill against revaluation reserve (which is now prohibited in some countries).
- Since SSAP 22 applies only to goodwill, finding an alternative epithet to describe acquired intangibles, and applying wholly different write-off criteria – hence the popularity of brands, titles, concessions, licences, trademarks, to name a few.
- Adopting merger accounting, if the necessary criteria are satisfied – and avoiding the creation of both goodwill and share premium.
- Using acquisition accounting and taking advantage legal provisions. Instead of a share premium account, creating a merger reserve which has a variety of uses, including scope for the write-off of goodwill on future acquisitions.
- Amortising goodwill "systematically" by means of an accounting policy ensures minimal impact on current and foreseeable earnings (such as annual write-off proportions based on reverse "sum-of-the-digits").

The issue of goodwill has been very controversial and seriously debated by academic and practising accountants all over the world today. A generally accepted definition of goodwill is yet to be identified. Different countries have different types of treatment for goodwill and there is not a standard that can provide a basic harmonisation in the area of accounting for goodwill. One view was in favour writing goodwill off immediately against reserves in line with the prudence concept. The opposing view was that of amortising goodwill over useful economic life in line with the accruals concept. A third view was to keep the goodwill permanently with no full write off or no amortisation. Therefore this represents the climate for the debate on "Accounting for Goodwill".

This research is carried out to give a detailed understanding of the accounting method for goodwill. Here, we will look into the definition of the nature of goodwill and development of goodwill accounting in different countries; investigate the principal controversy of systematic write-down of goodwill versus immediate write-off of goodwill; distinguish between internally generated goodwill and purchased goodwill; and provide observations on the general accounting treatment of goodwill in different countries.

We categorised this project into three parts, mainly to look into the historical viewpoint of goodwill, the present day goodwill and the prospect of goodwill in the future. Apart from that, we also discussed the work that had been done by the academics and also the issues surrounding the treatment of goodwill from the perspectives of different countries.

The historical trend

Definition of goodwill

One of the early definitions of goodwill can be found in Bithell's (1882) *A Counting House Dictionary*, where goodwill is described as a willingness of an owner of a business to relinquish the expectation of the business by transferring it for a consideration to someone else, which is known as "selling the goodwill of that business".

According to J.M. Yang (1927), to be of any value, goodwill must be more or less persistent and of definite duration, must exist as a result of a business acquisition and must be measurable in monetary terms.

Besides that, according to past literature, goodwill can also be defined through the excess profit approach. In the excess profit approach, goodwill is:

... simply conceptualised as the present value of a number of years of abnormal expected returns for the type of business concerned. Thus, in this view the total value of a business is the sum of the present values of the normal returns from the identifiable net assets, and the present value of the super-normal returns (Bryer, 1995).

Spacek (1964) defined goodwill as the present value placed on anticipated future earnings in excess of a reasonable return on producing assets. Thus, it is the cost to the buyer of earnings over and above the cost of the assets required to produce these earnings.

Ma and Hopkins (1988) defined goodwill as the capitalised value (i.e. the present value) of the future stream of superior earnings of the business to be acquired. Under this approach, earnings are determined and recorded as goodwill. However goodwill, as conceptualised by this definition, is very difficult to measure since future earnings cannot be predicted with certainty.

It is very important to note that the lack of agreement in the definition of goodwill will be followed by the lack of agreement in how to determine its treatment in the financial accounts once it has been recorded as a purchase cost (Lee, 1971).

Accounting for goodwill

From the literature perspectives. The first debate for accounting for goodwill was started in 1891 by Francis More. According to Francis More, the value of goodwill was expressed as a number of years purchase of net profits i.e. the price were found by multiplying the net profits by a factor. According to him, the purchaser of a business might reasonably expect a return (in lieu of a specified rate of interest) on his/her invested capital. This return should be

sufficiently high to compensate for the attendant risk. Thus he suggested that, a value should be attributed to goodwill only if a business was making a profit in excess of such a return (say 6 per cent to 10 per cent per annum) (see Table I).

On the other hand, Henry Rand Hatfield (1909) came up with two different approaches to goodwill valuation i.e.:

- (1) capitalise the net profits (before deducting an allowance for normal interest on tangible capital employed) to obtain the value of the whole business as a going concern and then subtract the value of the net tangible assets therefrom; or
- (2) capitalise surplus profits after interest.

According to Sulaiman (1994), the significance difference between both methods is that the first method indicates that one is actually valuing a stream of anticipated income. Thereby, goodwill is only a balancing item which arises due to the difference between this value and that of the tangible assets. However under the second method, each asset will be valued individually in an attempt to calculate its returns i.e. interest on capital employed. The excess of net profits over the interest or return on capital employed gives a surplus or "superior" profits. This signifies that the firm possesses "goodwill" and the value of goodwill is based on the capitalisation of surplus profit.

The valuation of goodwill which is based on a present value model is, however, very subjective. Egginton (1991) stated that:

The subjectivity and potential volatility of this overall assessment are among the reasons the PV model is not adopted in practice. A pure PV model would also offer the possibility of an unending series of revised expectations which are incapable of confirmation.

Besides that, in the past literature, the accounting treatment for purchased goodwill can be divided into three different viewpoints.

First, goodwill should be written off completely as soon as it is purchased (Spacek, 1964). Under this method, goodwill is immediately written off against an account in the shareholder's equity section, generally retained earnings. According to Spacek (1964), capitalisation and amortisation are arbitrary and understate net income. Therefore a better treatment is to write off goodwill immediately against retained earnings. Another rationale for the immediate write-off approach is that it is reasonable to expect that the goodwill relating to the business at the time of purchase will eventually disappear over time. This argument is based on the fact that the product of the business purchased will decline in importance. Therefore the particular goodwill purchased might well be written off. Advocates of this school also consider that goodwill will pose measurable difficulties and unlike other assets, in most cases cannot be separately sold. In these circumstances, carrying the asset in the balance sheet is of little value to users of accounts.

The second school of thought is that goodwill should not be written off at all, unless there is strong evidence to support this procedure. This school of

Year	Country	Standard	
1891 1909			First debated by Francis More Henry Rand Hatfield came up with two different approaches to goodwill valuation, i.e. (1) capitalise the net profits (2) capitalise surplus profits after interest
December 1944	USA	ARB 24	First official pronouncement by American Accounting Profession establishing appropriate valuation basis as cost
1953	USA	ARB 43	Prohibit immediate write off of goodwill against capital
1968-1969	Australia		Two academics, Wood and Mutton, argued strongly for the amortisation of goodwill against income. This was later supported by an audit and accounting discussion group
August 1970	USA	APB Opinion 16 APB Opinion 17	Purchased goodwill recorded at cost Purchased goodwill be capitalised or amortised against income over a maximum period of 40 years. Immediate write off prohibited Recognition of internally generated goodwill prohibited
1973 1973	USA Canada	CICA	FASB replaces APB A standard was announced similar to US pronouncement, this standard is silent on issue of internally generated goodwill
1974	Canada	CICA	Established an arbitrary maximum useful life of 40 years
1974 1977	Australia	IASC	Proposes a maximum life of 20 years Goodwill project was placed on the Australian Accounting Research Foundation (AARF) agenda
August 1978	New Zealand	SSAP 8	Establishes that any excess of cost of purchase over fair value of net asset be recorded as goodwill
1979	New Zealand	SSAP 8	Commented that revaluation of goodwill was not normal practice No requirement to amortise goodwill Goodwill to be shown on balance sheet as an intangible asset in the balance sheet
June 1980	UK		ASC proposed that purchased goodwill be systematically written off over its useful life in a discussion paper <i>Accounting for Goodwill</i> . However, the most widely adopted method is to write goodwill off in the year of acquisition
September 1981		IASC ED 22	Recommended that goodwill arising on acquisition be amortised to income on a systematic basis over its useful life

(continued)

Table I.
A chronology of the
development of
standards and issues
related to goodwill
accounting

Year	Country	Standard	
October 1982	UK	ED 30	Allowed companies either to write off goodwill in the year of acquisition, or capitalise and amortise goodwill over a recommended period of 20 years
November 1983		IAS 22	Two option of recognising goodwill: (1) Recognise as asset and amortise to income (2) Immediately adjusted against shareholder's interest (This reflected the international disharmony of goodwill accounting regulation)
March 1984	Australia	AAS 18	Statement of Accounting Standards AAS 18 'Accounting for Goodwill' was issued by the Australian Accounting Bodies
December 1984	UK	SSAP 22	Permitting amortisation of goodwill. Recommends direct write off of goodwill-this is consistent with not recognising internally generated goodwill
July 1987	Malaysia		A joint discussion paper on this matter was issued by the MIA and the MACPA- first attempt to standardise the accounting for goodwill
October 1987	New Zealand		SSAP 8 <i>Accounting for Business Combinations</i> issued to replace SSAP 8 and SSAP 2 <i>Accounting for Associated Companies</i>
1990	UK		Accounting Standards Committee came out with a proposal that goodwill will be capitalised and amortised over useful economic lives, with the restriction that their lives would not exceed 20 years and might never exceed 40 years
Early 1991			The MIA and MACPA again issued a revised joint discussion paper on goodwill accounting suggesting two options on the treatment of purchased goodwill, capitalisation with systematic amortisation or capitalisation as permanent item subject to periodic review
December 1993	UK		ASC came out with a proposal in a discussion paper, <i>Goodwill and Intangible Assets</i> † does not necessarily have to amortise goodwill but subject to impairment review
December 1993	UK	FRED 7	Accounting Standard Board (ASB) published FRED 7, <i>Fair Values in Acquisition Accounting</i>
1998	UK	FRS 10	FRS 10, <i>Goodwill and Intangible Assets</i> , has been issued – goodwill is to be treated as the same in SSAP 22
1998	IASC	IAS 22	IASC revised the IAS 22 – amortisation period may exceed 20 years, subject to impairment review

Table I.

thought base their arguments on the major points stated below (Zeff and Dharan, 1994):

- It is over-conservative to write goodwill off the books when it has not depreciated in value below the purchase price.
- When goodwill has actually depreciated, it is not necessary to record that depreciation in the operating account.
- It is impossible to determine accurately the extent to which the goodwill has depreciated.

The third school of thought says that goodwill should be amortised systematically over a reasonable period of time. Reasons for systematic amortisation will be summarised below:

- In accordance with a primary function of accounting to match cost and income, the cost of purchased goodwill should be amortised as a means of matching the cost of securing the income actually received.
- Under stewardship accounting, management should be required to justify its acquisition of other companies by demonstrating that cash inflows from the acquisitions exceed the cash outflows incurred when making the investment.
- According to the momentum theory of goodwill (Nelson, 1953), the buyer of a company normally pays a large sum of money for the goodwill because he wants a starting push in his new company, rather than to start fresh in a similar business and devote so much effort and money over long period of time to develop such goodwill.

Goodwill is acknowledged for accounting purpose only when it is purchased as part of a takeover. In practice all businesses develop internally generated goodwill as they grow and relations are developed with suppliers, customers and the work force. Until recently, there was no attempt made to account for anything other than purchased goodwill. The reasons given by Lee (1971) were:

- The acquired conservatism of accountants, combined with a fear that created goodwill may well be a fictitious asset introduced to improve the financial position of the business described in its balance sheet.
- Certain generally accepted concepts of accounting which are extremely difficult to apply in practice to goodwill-that is historic cost, objectivity and verifiability.
- The difficulty of annually revaluing goodwill. Such an exercise has to be based on several assumptions, including the estimations of future profits and of what is a reasonable rate of return for the particular business.
- The difficulty in capitalising the business costs which are contributing to the value of goodwill-for example, the cost of research or

advertising expenditure. Which part of the total advertising expenditure of the business contributed to the sales that generated the profits related to goodwill? Such an allocation exercise would be, at best artificial.

The above discussion was based solely on works done by academics. Now we shall look at the issues surrounding the treatment of goodwill from the perspectives of different countries.

The development of accounting standards for goodwill accounting of different countries

USA. The goodwill issue was being debated in the American literature and courts in the early 1900s. However, the first official pronouncement by the American accounting profession was only release on December 1944. The *Accounting Research Bulletin No. 24* (Committee on Accounting Procedure, 1944) adopted a traditional historical approach to the intangible, including goodwill, establishing costs as the valuation basis. In those days, internally generated goodwill was not discussed. The Bulletin recognised two types of purchased goodwill. It recommended that goodwill with a limited term of existence be amortised systematically to income. If there is no indication on the limited term, than goodwill will either be retained at cost until evidence indicated limited existence, or amortised to income on some systematic basis. Another way of treating goodwill is to write-off the goodwill against capital immediately. However, this approach was not recommended by the Bulletin although that it is permitted on the ground that the practice had been long established and widely approved (Committee on Accounting Procedure, 1944).

In 1953, the ARB No. 43 *Restatement and Revision of Accounting Research Bulletins* (Committee on Accounting Procedure, 1953) prohibited the option of immediate write-off of goodwill against capital. In August 1970, the Accounting Principles Board (APB) of the American Institute of Certified Practising Accountants released APB Opinions 16 *Business Combinations* (APB, 1970a) and 17 *Intangible Assets* (APB, 1970b). Opinion No. 17, operative in respect of intangible assets including goodwill acquired after 31 October 1970, retains the traditional historic posture adopted in ARB No.24. Purchased goodwill is to be recorded at cost with the amount to be calculated by reference to the fair value of the identifiable net assets acquired and the fair value of the purchase consideration. The purchase consideration may be measured either "by the fair value of the consideration given or the fair value of the property acquired whichever is the more clearly evident." Opinion No. 17 requires purchased goodwill to be capitalised and amortised against income over a maximum period of 40 years. The immediate write-off of goodwill in the year of acquisition is specifically prohibited, as is the recognition of internally generated goodwill.

Canada. The Canadians followed the Americans and in December 1973 the Canadian Institute of Chartered Accountants (CICA) issued CICA Section 1580 "Business Combinations" to apply from 3 March 1974. This document based on the ED (CICA, 1973) issued a year earlier, is very similar to the US pronouncement in requiring purchased goodwill to be capitalised and amortised over a period of 40 years. However, the Canadian document is silent on the issue of internally generated goodwill.

New Zealand. Statement of Standard Accounting Practice No. 8 (SSAP 8) *Consolidated Financial Statements* (New Zealand Society of Accountants, 1978) was issued by the New Zealand Society of Accountants in August 1978. The statement required that under the purchase method of accounting for business combinations the cost of purchase be recorded at the fair value of the consideration given and any excess of the cost of purchase over the fair values of the net assets be recorded as goodwill. SSAP 8 did not require to amortise goodwill. Goodwill was required to be shown as an intangible asset in the balance sheet to the extent that it had not been amortised or written down. In addition the unamortised portion of goodwill was to be written down where there had been a permanent impairment in value.

SSAP 8 and SSAP 2 *Accounting for Associated Companies [Equity Accounting]* were subsequently replaced by SSAP 8 *Accounting for Business Combinations* issued in October 1987 to apply from 1 January 1988. One of the major changes from the earlier SSAP 8 is the requirement that goodwill be amortised to the profit and loss over the period of expected benefit. No maximum amortisation period is specified in the standard. However in the discussion paper, it states that the period over which goodwill should be amortised "would be unlikely to exceed ten years and should in no case exceed 20 years".

Australia. In Australia, as in other parts of the world, a variety of accounting practices were used to account for goodwill in the absence of an accounting standard. This is evidenced by studies specifically related to goodwill on consolidation, undertaken by Gibson and Francis (1975) and Goodwin (1986), and other general surveys of financial reporting practices conducted by Standish (1972) and Ryan and Tibbits (1996). The goodwill project was placed on the Australian Accounting Research Foundation (AARF) agenda in late 1977 and in December of that year a goodwill discussion paper was commissioned. The AARF received the first draft of the paper from Ernst and Whinney in August 1978 and a revised paper in May 1980. The first goodwill exposure draft was issued selectively by the Accounting Standards Board of the AARF 13 months later, and in May 1983, five-and-a-half years after the commencement of the goodwill project, the amended draft was issued for public comment.

Statement of Accounting Standards AAS 18 *Accounting for Goodwill* (Australian Accounting Bodies, 1984) was issued by the Australian Accounting Bodies in March 1984 to apply from 31 March 1985. AAS18 requires that purchased goodwill, measured as the excess of the purchase consideration over the fair values of the identifiable net assets acquired, be recognised as an asset, and systematically amortised over a maximum period of 20 years. The amortisation of goodwill through the profit and loss is consistent with the all-inclusive concept of income which was adopted in AAS1 in an attempt to eliminate the practice of writing off items such as goodwill against reserves or retained profits.

UK. A discussion paper *Accounting for Goodwill* (ASC, 1980) issued by the UK Accounting Standards Committee (ASC) in June 1980 suggested that purchased goodwill be systematically written off over its useful life. Reactions to the discussion paper was mixed. The method used widely at the time was to write off in the year of acquisition. However, strong support was also shown for the capitalisation / amortisation approach.

ED30 *Accounting for Goodwill* issued in October 1982 allowed companies either to write off goodwill in the year of acquisition, or capitalise and amortise goodwill over a recommended period of 20 years or less. The recognition of internally generated goodwill was not permitted.

Statement of Standard Accounting Practice No. 22, SSAP 22, *Accounting for Goodwill* was issued in December 1984. Although permitting the amortisation of goodwill over its useful economic life, the statement recommends the direct write off of goodwill against reserves. This recommendation is justified on the basis that the treatment is consistent with not recognising internally generated goodwill.

International. The International Accounting Standards Committee was founded in June 1973 to foster the improvement and world-wide harmonisation of accounting regulation, standards and procedures. In September 1981, the Committee issued ED22 *Accounting for Business Combinations* (International Accounting Standards Committee, 1981). The exposure draft recommended that goodwill arising on acquisition, defined as the excess of the purchase price over the assigned values of the net identifiable assets acquired, be amortised to income on a systematic basis over its useful life.

However, International Accounting Standard 22 (IAS 22) *Accounting for Business Combinations* (International Accounting Standards Committee, 1983), published in November 1983 reflects the current international disharmony of goodwill accounting regulation. The Standard allows any difference between the cost of acquisition and the fair value of net identifiable assets acquired to be either recognised as an asset and amortised to income on a systematic basis over its useful life, or immediately adjusted against shareholders interests. IAS 22 does not indicate a preferred approach. However, there are moves to amend this standard by the International Accounting Standards Committee in 1989.

The present trend

Accounting for goodwill

From the literature perspectives. In the 1990s, another approach to define goodwill came about, which was called the residuum approach. In the residuum approach, goodwill is defined as the difference between the purchase price and the fair market value of an acquired company's asset. Goodwill is a left over amount that cannot be identified, after a thorough investigation, as any other tangible or intangible asset (Johnson, 1993).

According to Grinyer *et al* (1990):

... a root of cause of apparent confusion concerning the treatment of goodwill, as in many other accounting matters, arises because of a failure to identify what the accounts are trying to measure and the purpose that they serve.

Their argument is based on two distinct conceptual models (matching and valuation approach), which are essentially mutually exclusive within a single profit and loss account, yet, in practice many theorists failed to differentiate between the two models, and as a result they believed that their model should be superior to the others.

The valuation concept in accounting can be defined as the difference of values at two different dates. Hendriksen (1977) defined valuation in accounting as a process of assigning meaningful quantitative monetary amounts to asset. The relevant valuation concepts should be based on exchange or conversion values. There are two types of exchange values. First, the output values which reflect the expected funds to be received by the firm in the future, based particularly on the exchange price for the firm's product or output. Second, input values, which reflect some measure of the consideration given up in obtaining the assets used by the firm in its operation (Hendriksen, 1977).

The matching concept has been defined by the American Accounting Association (AAA) committee in 1964 as the process of reporting expenses on the basis of a cause and effect relationship with reported revenues. The committee advocated that costs (defined as product and services factor given up) should be related to revenue realised within a specific period on the basis of some discernible positive correlation of such costs with the recognised revenues (Hendriksen, 1977).

Issues surrounding the treatment of goodwill from the perspective of different countries

UK. The debate over how to account for goodwill and intangible assets has been going on over a decade. Goodwill has appeared to be an umbrella concept embracing many features of a company's activities that could lead to superior earning power, such as excellent management, an outstanding workforce, effective advertising and market penetration. In developing the accounting

treatment of goodwill in SSAP 22, the Accounting Standard Committee have three alternative to choose from:

- (1) retention of the cost as an asset with amortisation required over its estimated limited life or over an arbitrary period with a specified maximum or minimum period;
- (2) retention of the cost as an asset indefinitely unless a reduction in value is evident; or
- (3) the deduction of the cost from shareholders' equity at the date of acquisition.

The arguments used against amortisation are that the net income should not be reduced by both depreciation and by expenditure intended to maintain the value of goodwill, that any period of amortisation is in essence arbitrary, as the life of goodwill is indefinite and that the selection of an arbitrary period for amortisation can lead to an understatement of net income during the period and an overstatement later.

The argument in favour of retaining acquired goodwill as an asset is that its book value should not be reduced as long as the value of the asset appears unlikely ever to fall below that cost. This method is criticised as acquired goodwill is deemed eventually to be replaced with self generated goodwill.

Finally, the argument for proposing that the cost of goodwill be deducted from shareholders' equity is that, as the nature of goodwill differs from that of other asset, it should not be shown as an asset and therefore requires special accounting treatment. In particular, it is argued that as goodwill relates to the business as a whole, its value can fluctuate depending on stock market conditions. As a consequence of its uncertain value and its indeterminate useful life, amortisation of goodwill would be too unreliable to be used for annual income determination. The criticism directed against this option is that it confuses non-accountants and can lead to misinterpretation of a company's financial position.

The Accounting Standard Board has been using SSAP 22 for the elimination of goodwill. It permits two different elimination for purchased goodwill, either to write it off against reserves, or to capitalise goodwill and amortise it over its useful economic life. However, the first option is preferred and used by most of the industry in the UK. This method ensures that there will be no charge to the profit and loss account unless there is a subsequent disposal or closure of the business involved. The problem of writing off goodwill against reserves is that the balance sheet of an acquisitive group can become ended quickly and it gives the appearance that the group has very low or even negative net worth.

In 1990, the Accounting Standards Committee came out with a proposal where that goodwill will be capitalised and amortised over their useful economic lives, with the restriction that their lives would not exceed 20 years

and might never exceed 40 years. The proposal was strongly objected. About 93 per cent of the corporate respondents to the ED 47, *Accounting for Goodwill* indicated that they were opposed to mandatory amortisation of goodwill. Later on, the Accounting Standard Board (ASB, 1993a) re-examined the issue and came out with a proposal in a discussion paper, *Goodwill and Intangible Assets* issued in December 1993. In the proposal, it was stated that the ASB allows goodwill not to be charged to the profit and loss account through the annual amortisation charges, but a write-down would be required only where the goodwill had suffered impairment in value. Impairment review is a formal test to be performed at a specified points in time or after particular events have occurred, to ensure the asset's carrying value has not fallen below its recoverable amount.

On the other hand, there has also been some issue about negative goodwill. According to one of the article that was published in *The Journal of the Institute of Chartered Accountants* in Ireland, December 1990, negative goodwill generally arises because of a "bargain purchase" (for example, where a seller wants to sell quickly, or at an adverse time and the purchase is willing to buy quickly) or "disadvantages" existing which are not included in the calculation of the fair value of the net assets acquired. The correct accounting treatment of this negative goodwill is to consider its nature, and where it arises, due to bargain purchase, to credit it to unrealised reserves and to feed it into the profit and loss account as the assets are sold or depreciated. If it arises due to disadvantages it should be accounted for as a provision against which the disadvantage may be charged when it arises. Therefore, simply to credit it to unrealised reserves and leave it there, as suggested by SSAP 22 is clearly not correct.

In December 1993, the Accounting Standard Board (ASB, 1993b) published FRED 7, *Fair Values in Acquisition Accounting*. In this discussion paper, the Board looks at the possible ways to account for goodwill and intangible assets. Six different approaches are examined, an indication that there are problems in reaching a solution to the accounting for goodwill problem. Generally, there is two approach that got the most support which were first, a combination of the capitalisation methods so that amortisation over a maximum period of 20 years would be required in most cases, but in cases where the goodwill is believed to have life of greater than 20 years, a ceiling test be conducted. The ceiling test is used to determine the life of goodwill.

Under the ASB (1996) proposals goodwill would be brought to account as an asset and amortised if:

- its useful life is less than 20 years;
- the value of goodwill is not significant; or
- its useful life is over 20 years but finite.

If none of these circumstances applied, and there was no impairment of value, the asset could be carried without amortisation, provided that its carrying amount was checked annually throughout an "impairment review".

FRS 10, *Goodwill and Intangible Assets*, has been issued and is effective for accounting periods ending on or after 23 December 1998. Goodwill is to be treated as the same in SSAP 22, either by amortisation through the profit and loss account over the expected useful life, or to write it off direct to reserves. FRS 10 will require most of the companies to change their accounting policy on goodwill to adopt a method of capitalisation and amortisation. Its main requirement for goodwill is that purchased goodwill should be capitalised and classified as an asset on the balance sheet. However, negative purchased goodwill should be recognised and separately disclosed on the balance sheet and accounted as deferred credit, immediately below the goodwill heading. Internally generated goodwill should not be recognised at all.

The useful economic lives of purchased goodwill should not exceed 20 years. The carrying value should be amortised in the profit and loss account on a systematic basis over the estimated useful life. However, if the useful economic life is believed to be exceed 20 years, and the value of the goodwill is significant and expected to be a continuous measurement in the future, there are two ways of treating it. If the economic life can be estimated, the carrying value should be amortised in the profit and loss account over the useful economic life. If the useful economic life is indefinite, the goodwill should not be amortised. Impairment is required for both the ways for treatment of the goodwill.

FRS 10 is generally an acceptable solution and should finally end the goodwill debate for UK. It is proposed on accounting treatment for goodwill is internationally accepted and being practised.

There is an issue raised in the accounting for internally generated goodwill. It is argued that there is no fundamental difference in nature between internally generated and purchased goodwill, in fact purchased goodwill could be defined as being internally generated goodwill valued objectively by transaction at a specific point in time. Thus, the argument was that both kinds of goodwill could be included on the company's balance sheet to ensure comparable financial statements between acquisitive companies and companies preferring organic growth, with the assumption that purchased goodwill are not written off to reserves immediately. On the opposite side, it is argued that although it is true that no difference exists between two types of goodwill, only purchased goodwill could be recognised in the context of historical cost accounting because it results from a market transaction which crystallises its value at one point in time, and because the historical cost balance sheet does not purport to represent the total value as a business as a whole. Besides that, it also can be argued that reader of financial statement could always make the necessary adjustments before comparing the results of the groups that had grown

organically with those of groups that had grown by acquisition. The accounting profession has been supporting the latter argument.

Australia. Goodwill is defined in AASB 1013 as the future benefits from unidentifiable assets. Examples of unidentifiable assets include market penetration, effective advertising, and good labour relations. AASB most recent standard on the accounting for goodwill requires that goodwill be amortised “on a straight line basis, from the date of acquisition, to the end of the period of time during which the benefits are expected to arise.” The period must not exceed 20 years.

Before this, in Australia, the practice of amortising goodwill was using the method known as “inverted sum of the years’ digits” (ISOYD). This method allowed for a small goodwill writes off in the early years after acquisitions with compensating increased provisions in later years. This practice had been criticised as unlikely to meet the requirements of AASB 1013.

The definition of goodwill that is provided in AAS 18 is the same as the definition in AASB 1013. This definition applies to both purchased goodwill and internally generated goodwill. Only purchased goodwill is being recorded in the account because of the problems associated with obtaining the objective and reliable measurement of internally generated goodwill. Purchased goodwill is an asset and should be accounted for, as it is a payment for the future benefits. The amount recorded is the excess of the purchase consideration over the fair values of the net identifiable assets acquired. Once recorded, goodwill should be amortised over its useful economic life, subject to the period of 20 years. This accounting method is similar to those practised by Canada and USA and are consistent with the International Accounting Standards (IAS 22). However, there are argument relates to the treatment of the accounting method on goodwill.

AAS 18 requires that purchased goodwill should be amortised. The justification for the amortisation is that purchased goodwill has a limited life and it is constantly being taken over by the internally generated goodwill. However, since internally generated goodwill is not recognised, purchased goodwill must be written off over its useful life the same way as depreciable assets are written off over their useful lives. It is to be written off with the maximum of 20 years.

Goodwill amortisation can be used as an income manipulation and smoothing device. This is because AAS 18 also requires that the amortisation policy should be reviewed at each balance sheet date and adjustments are to be made where necessary. This means that management is permitted to write off goodwill whenever it desires.

The approach adopted in the Australian Statement is the cost principles. Under the historical cost accounting, asset should be recorded at the price paid for them. Therefore, the acquisition should be recorded at its costs. When the cost exceeds the fair values of the net identifiable assets acquired, it is assumed

that the excess represents a payment for goodwill. These may be inherent in the business entity being acquired or may be created as a result of the combination.

One of the problems that arise from cost principle is the inconsistency between internally generated goodwill and purchased goodwill. The concept of goodwill is the same regardless of how it has been acquired and therefore, there is no theoretical justification for a different accounting. The example given by the AAS 18 on the unidentifiable assets include market share, advertising, good labour relations and superior management and staff. It is not usually possible to relate the future benefits from these assets to particular expenditures and they are therefore not recognised in the accounts. The differences of accounting treatment for purchased and internally generated goodwill may cause the reduction in the comparability between the financial statement of those companies that have grown internally and those that grown for the acquisition of other entities.

Other arguments have been used against the recognition of goodwill as an asset. Catlett and Olsen (1968) argued that purchased goodwill has no separate existence after and acquisition, it cannot be exchanged in its own right and becomes merged with total goodwill. Chambers (1996) suggested that goodwill is an asset belonging to the owners of an entity rather than to the entity itself. Those who do regard goodwill as an asset belonging to the entity argue that the different characteristics attaching to goodwill are irrelevant. The fact that it represents a payment for future benefit means that, in accordance with the cost principle, it must be recorded as an asset. There are, therefore, conceptual arguments in support of both viewpoints. These depends on one's interpretation on what an asset really is and what the cost principle should always be referred to.

It can be argued that to record goodwill as an asset and to amortise it is likely to lessen the usefulness and comparability of financial statements. When purchased goodwill is to be amortised, at the same time, the factors that give rise to internally generated goodwill are also being expensed, resulting in a double counting. Companies with purchased goodwill will report more assets and less income than those, which have grown internally. Moreover, the amount of amortisation depends on the amortisation policy chosen by the company.

USA. In the USA, amortisation of goodwill is required and as at June 1999, the maximum amortisation period is 40 years but it is being proposed that the period be shortened to 20 years with rebuttable presumption of ten years.

New Zealand and Canada. As at June 1999, there are no significant changes to the accounting standards in these countries as stated in our earlier discussion.

International. One of the major problems that are being faced by the IASB is that in some countries, "other internationally recognised" standard is being

favoured over the ISA. Hence in 1998, the IASC revised the IAS 22. In the revised standard, it continues to call for the strict capitalise and amortise approach to goodwill. Amortisation is still mandatory but the amortisation period may exceed 20 years, subject to impairment review (see Table II).

A Malaysian perspective

Placed in the perspective of the modern corporate world, goodwill and other intangible assets are bound to become more and more significant as corporations build up their strengths around technology and human assets. In the current era of communication and information technology, intangible of various kinds are gradually replacing physical tangible assets as critical success factors for many modern-day corporations.

This paragraph is adapted from one in the article in *Malaysian Accountant* written by Tan (1992).

The first attempt to standardise the accounting for goodwill was seen to be made during July 1987. A joint discussion paper on this matter was issued by the Malaysia Institute of Accountant (MIA) and the Malaysian Association of Certified Public Accountant (MACPA). Comments were collected from members, firms, companies listed on the KLSE, relevant regulatory agencies, and statutory bodies and other interested organisations.

An analysis of the responses indicates that there was a clear support for the discussion paper's recommendation for purchased goodwill to be written off in the year of acquisition. Furthermore, there is a majority agreement that if the goodwill is not eliminated against reserves, it should be amortised against pre-tax profit over its useful economic life.

As might be expected, the principal area of disagreement lay in defining the amortisation period. Whilst about half of the respondents were in favour that no definite amortisation period be prescribed, the other replied in support of an upper limit with five to 20 years being generally favoured.

	USA (APB17)	Canada (CICA 1580)	New Zealand (SSAP18)	Australia (AAS18)	IASC (IAS22)	UK (SSAP 22)
Record as an asset	Yes	Yes	Yes	Yes	Possible	Possible
Amortise to income	Yes	Yes	Yes	Yes	Possible	Possible
Maximum amortisation period	40	40	410-20	20	5-10	40
Write-off to reserves	No	No	No	No	Possible	Preferred
Period-off amortisation	Benefit period	Useful life	Benefit period	Benefit period	Useful life	Useful life
Amortisation basis	S/L	S/L	Systematic	S/L	S/L	S/L
Practice	S/L	S/L	S/L	S/L	-	S/L

Notes: S/L – straight line

Sources: Carnegie and Gibson (1991, p. 13) and Australia Accounting Research Foundation (1995)

Table II.
Professional accounting
requirement for
goodwill at
international
perspective

As the analysis of replies indicate, the proposal of a combination of accounting policies (with clear description in the notes to the account) was favoured by the majority of respondents but with a significant degree of opposition.

Comments on this proposal indicate that those in favour of the proposal emphasised that different acquisition, particularly in different industries, merit different accounting treatments.

Those opposed to the proposal, expressed concern that the flexibility would lead to abuse or, at least, to lack of comparability between accounts, thereby undermining the fundamental purpose of the standard. As a minimum, if two methods were to be permitted, a few respondents recommended that clear guidelines should be laid down as to which method should be used under what circumstances.

Unfortunately, this discussion paper only ended at the stage of exposure draft as it received diverse responses from the public. In 1980s, with the rapid growth of corporate sector in Malaysia, the issue on goodwill arises again. Tan (1992, 1997) noted that "franchises and patents have been bought and sold, concessions and toll rights have appeared in corporate annual accounts, and more recently, goodwill of significant magnitudes have been reported on acquisitions involving gaming and banking businesses." In early 1991, the MIA and MACPA again issued a revised joint discussion paper on goodwill accounting, proposing that purchased goodwill should be recognised as an asset but internally generated goodwill should not be recognised. It suggested two options on the treatment of purchased goodwill, capitalisation with systematic amortisation or capitalisation as permanent item subject to periodic review.

Although that debate has been going on regarding the issue of goodwill, there is not much that has been done to on setting up the standard on goodwill. No effort is being taken to examine the current state of the art practices among Malaysian companies. The accounting method for goodwill is so flexible that sometimes we tend to question on the validity of this flexibility, particularly on the terms of attaining comparability of financial statements. This resulted in abused goodwill accounting, which is the "polluted purchase" (Kam, 1990) employed for business combinations. Many companies used the lower book values of net assets instead of using the fair values of the net assets acquired in the allocation of the purchase consideration, resulting in large balancing goodwill figure. This enables the corporation to lower its depreciation charges and the absence of goodwill amortisation. The basic problems in both the treatment of the accounting for goodwill is that using the immediate write-off method, could adversely deplete the equity base of the reporting entity, thereby distorting its gearing position. The amortisation method on the other side would severely reduce the reported profits and earnings per share, in which they are the important market indicators for the companies.

Prospects of goodwill accounting: the future

In the future, the definition of net identifiable assets may not be applicable anymore. For example, right now we can see the emergence of the concept of online storefront whereby a company exists solely in the cyberspace. This online storefront will not have any identifiable assets. This will lead to an increasing importance of intangible assets. The value of the company will be based mostly on the value of the intangible assets mainly from newly emerging intellectual capital, its accounting treatment and reporting in knowledge economy. Therefore, the need to recognise internally generated goodwill will be more critical. Currently, no recognition is given to the internally generated goodwill. This means that problem will arise regarding this matter in the future.

In this era, we see that consumer tastes and preferences change very fast. Consumer demand for new products all the time. Something which is sought after now may be outdated in a few months time. For example, things that have very short life span are like clothes, handphones and computers. According to Nelson (1953), goodwill comprises customer list, organisation costs, development costs, trademarks, trade names and brand, secret processes and formulae, patents, copyrights, licences, franchises and superior earning powers. Therefore, goodwill according to trademarks, copyrights, trade names and brand etc. may not be applicable anymore in the future as consumer taste changes even faster.

Besides that, in the future, there might not be any monopolistic industry. For example, in Malaysia, we can see that a lot of industries are going for perfect competition. One of the evidence is, there is more than one telephone service provider beside Telekom Malaysia, such as Maxis, Digi, etc. Therefore, goodwill according to superior earning powers might not be applicable in the future.

Conclusion

From our discussion, we can see that the goodwill problem is not a new problem. In fact academics and researchers have discussed it since the 1890s. However, until now there is still no obvious solution to the problem. In the 1980s and the 1990s, we can see that there are still many controversies on the valuation of goodwill and on the proper accounting treatment of goodwill.

As we enter the new millennium, it is important that the accounting profession and the proper authority take the necessary step to put the issue of goodwill to rest once and for all. The issue of goodwill has been going long enough. Therefore, it is time for all parties related to work together to find a solution to this problem whereby everybody agrees to it. This is important as to contribute to greater uniformity in accounting for goodwill and enable comparability to be made. Besides that, it is hoped that the controversies surrounding goodwill can be minimised. To find a sound solution to the issue

of goodwill, other aspects of accounting such as brand accounting, taxation and merger need to be reviewed. The emergence of intellectual capital, its accounting and reporting add considerable significance and there is an urgent need to solve the accounting issues of goodwill.

On the international level, the duty to find a solution to the goodwill problem will fall largely on the shoulder of the International Accounting Standard Committee (IASC). The IASC needs to carry out its duty which is to foster the improvement and world-wide harmonisation of accounting regulation, standards and procedures. A strict solution to the treatment of goodwill need to be achieved by the IASC and they need to make sure that countries comply with the standards to improve standardisation of practices among countries.

Currently, the Malaysian Accounting Standard Board (MASB) is in the midst of preparing a standard for goodwill. Hopefully, MASB will come up with a solution to resolve the issue of goodwill, with relevance to the IASC standard of goodwill but suited to the Malaysian context.

Finally, it is also important to note that, the accounting treatment of goodwill need to be reviewed from time to time, to see if any new issues of goodwill has emerged and to revise the standard to the current accounting needs.

References

- Accounting Principles Board (APB) (1970a), *Business Combinations*, APB Opinions 16, August, APB.
- Accounting Principles Board (APB) (1970b), *Intangible Assets*, APB Opinions 17, APB.
- Accounting Standard Board (ASB) (1993a), *Goodwill and Intangible Assets*, December, ASB.
- Accounting Standard Board (ASB) (1993b), *Fair Values in Acquisition Accounting*, Financial Reporting Exposure Draft, FRED 7, December.
- Accounting Standard Board (ASB) (1996), *Goodwill and Intangible Assets*, Financial Reporting Exposure Draft, FRED 12, June, ASB.
- Accounting Standards Committee (ASC) (1980), *Accounting for Goodwill*, June, ASC, London.
- Australian Accounting Bodies (1984), *Accounting for Goodwill*, AAS 18, Australian Accounting Bodies.
- Bithell, R.A. (1882), *A Counting House Dictionary*, George Routledge & Sons, London.
- Bryer, R.A. (1995), "A political economy of SSAP 22: accounting for goodwill", *British Accounting Review*, Vol. 27, pp. 283-310.
- Catlett, G.R. and Olson, N.O. (1968), "Accounting for Goodwill", *Accounting Research Study*, AICPA, New York, NY.
- Canadian Institute of Chartered Accountants (CICA) (1973), *Business Combinations*, CICA Section 1580, CICA, Toronto, December.
- Chambers, R.J. (1996), *Accounting, Evaluation and Economic Behavior*, Prentice-Hall, Englewood Cliffs, NJ.
- Committee on Accounting Procedure (1944), *Accounting Research Bulletin No. 24*, Committee on Accounting Procedure.

- Committee on Accounting Procedure (1953), *Restatement and Revision of Accounting Research*, ARB No. 43, Committee on Accounting Procedure.
- Egginton, D. (1991), *Testing Goodwill: A Case Study*, ACCA Occasional Research Paper No. 8, Chartered Association of Certified Accountants, pp. 1-19.
- Goodwin, J. (1986), "Australia's AAS 18 – has it solved the goodwill problem?", *Accountants Journal*, September.
- Grinyear, J.R., Russell, A. and Walker, M. (1990), "The rationale for accounting goodwill", *British Accounting Review*, Vol. 22 No. 3, pp. 223-35.
- International Accounting Standards Committee (1981), *Accounting for Business Combinations*, International Accounting Standards Committee, London.
- International Accounting Standards Committee (1983), *Accounting for Business Combinations*, IAS 22, November, International Accounting Standards Committee, London.
- Jean, A. (1990), "Le 'Goodwill' – un autre point de vue", *Accountancy*, February.
- Johnson, J.D. (1993), "Goodwill: an eternal controversy", *The CPA Journal Online*, April.
- Lee, T.A. (1971), "Goodwill – further attempts to capture the will-o'-the-wisp", *Accounting and Business Research*, Vol. 24 No. 93, Winter, pp. 79-91.
- Ma, R. and Hopkins, R. (1988), "Goodwill – an example of puzzle solving in accounting", *Abacus*, Vol. 24 No. 1.
- Nelson, R.H. (1953), "The momentum theory of goodwill", *Accounting Review*, pp. 491-9.
- New Zealand Society of Accountants (1978), *Consolidated Financial Statements*, Statement of Standard Accounting Practice No. 8, New Zealand Society of Accountants, August.
- Spacek, L. (1964), "The treatment of goodwill in the corporate balance-sheet", *The Journal of Accountancy*, p. 35.
- Sulaiman, L. (1994), "Literature review on accounting for goodwill", *Accamadia Journal of School of Accounting MARA, Institute of Technology*, December.
- Tan, L.T. (1992), "Goodwill and identifiable intangible assets", *Malaysian Accountant*, April.
- Tan, L.T. (1997), *Financial Accounting and Reporting in Malaysia*, MACPA – Thomas Information (SE Asia).
- Woolf, E. (1990), "Arguments in the goodwill debate", *Accountancy*, May.
- Woolf, E. (1996), "Intangibles – an alternative view", *Australian Accountant*, May, pp. 50-2.
- Zeff, S.A. and Dharan, B.G. (1994), *Readings and Notes on Financial Accounting*, 4th ed., McGraw-Hill, Maidenhead, Ch. 4.

Further reading

- Acher, G. (1994), "One step forward, one step back", *Accountancy*, February.
- Barker, C.P. (1990), "Goodwill ruffles feathers", *Accountancy Ireland*, December.
- Carnegie, D.G. (1996), *Accounting History Newsletter 1980-1989 and Accounting History 1989-1994*, Garland Publishing, New York, NY and London.
- Carlsaw, C. (1985), "Goodwill – against revaluations", *Accountants Journal*, December.
- Carlsaw, C. (1986), "Goodwill – anything goes", *Accountants Journal*, August.
- Chitty, D. (1998), "Goodwill – the final solution", *Accounting Technician, The Journal of the Association of Accounting Technician*, April.
- Grant, S. (1996), "Goodwill, the debate that never ends", *Australian Accountant*, December.

- Ibrahim, M.K. (1996), "Accounting for goodwill – theoretical and conceptual arguments", *Accademia Journal of School of Accounting MARA, Institute of Technology*, June.
- Johnson, T.L. and Petrone, R.K. (1998), "Is goodwill an asset?", *Accounting Horizons*, September.
- Kennedy, S. (1994), "Goodwill – there is no obvious solution", *Accountancy*, February.
- Kennedy, S. (1995), "Unresolved goodwill", *Accounting Technician, The Journal of the Association of Accounting Technician*, August.
- (The) *Malaysian Accountant* (1988), "Accounting for goodwill – summary of comment on discussion paper", January-March.
- Paterson, R. (1998), "FRS10 hit the target?", *Accountancy*, February.
- Ryan, J. and Tibbits, G. (1997), "Counting the cost: HCA and intangibles", *Australian Accountant*, October.
- Street, D., Gray, S. and Bryant, S. (1999), "Goodwill – a story without end?", *Accounting and Business*, June.
- Tollington, T. (1994), "Open season on goodwill", *Management Accounting*, April.