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Accounting for goodwill; Accounting research study no. 10

George R., 1917- Catlett

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AN ACCOUNTING RESEARCH STUDY

ACCOUNTING FOR GOODWILL

By George R. Catlett and Norman O. Olson

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ACCOUNTING
FOR
GOODWILL

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By George R. Catlett and Norman O. Olson
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Contents

Director's Statement

Problems in accounting for goodwill are not new. Perhaps accounting for goodwill has changed more often during the last century and has resisted longer efforts to find a lasting solution more or less acceptable to accountants, management, and financial statement users than any other element reported in financial statements. The last twenty-five years have seen significant changes in generally accepted accounting principles related to goodwill, and dissatisfaction with accepted practice has increased in recent years.

Problems in accounting for business combinations are more recent in origin. In fact, heated discussion of business combinations in accounting literature was virtually unknown before World War II. In the post-war period, however, varied organizational and financial arrangements for business combinations developed, accompanied by imaginative accounting procedures and new terminology. Not only has pooling of interests accounting become widely accepted, but accounting has also had to contend with combinations described as part pooling and part purchase, "downstream" mergers, acquisitions carried out with treasury stock or convertible securities, and a variety of other forms of business combinations. Increasingly, accounting for business combinations has been criticized by accountants and non-accountants alike.

Accounting for goodwill and accounting for business combinations are conceptually distinct problems. The proper valuation of resources, tangible or intangible, is a broad and vital problem in accounting, but it is a different problem from that of interpreting the nature of a business combination. Maurice Moonitz made that point in the Director's Preface to *Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations" by Arthur R. Wyatt. That study dealt only with business combinations and did not consider the problems of accounting for goodwill.

In practice, however, the subjects of goodwill and business combinations have become intertwined. The difference between the cost of an investment and the fair value of the net assets acquired, other than goodwill, must be recognized in accounting for a business combination as a purchase, whereas existing carrying amounts are retained in a pooling of interests and neither "costs" nor fair values are recognized. The differences between these two accounting methods, coupled with the accounting for intangibles required by Chapter 5 of *Accounting Research Bulletin No. 43*, have been major influences in the development of accounting for business combinations. When *Accounting Research Study No. 5* was published in 1963, the Accounting Principles Board agreed that it should consider the two subjects together, and this study of goodwill was authorized.

George R. Catlett and Norman O. Olson therefore undertook a monumental task—to attempt to find simultaneous solutions to two conceptually distinct but practically interdependent accounting problems, solutions which had so far eluded the best efforts of the profession. I wish to express my appreciation to them and to Arthur Andersen & Co., the firm of which they are partners, for their efforts in behalf of the accounting research program.

Members of the project advisory committee provided valuable assistance by reviewing drafts of the manuscript and meeting several times to advise the authors and the Director of Accounting Research. A majority of the committee favors publication of the study, and all members have contributed comments which are published following the study (pages 116 to 161). Approval of publication by a committee member or restriction of his comments to specific parts or aspects of the study should not be interpreted as his concurrence with the contents, conclusions, or recommendations of the study.

In my opinion, this study falls short of meeting the qualifications of an accounting research study, and I have authorized its publication with reservations. I have attempted to evaluate the theory or logic of the arguments presented in the study to determine whether the conclusions are in fact supported. Even ignoring the considerable quantity of material which I believe to be extraneous, I doubt that the logic can be traced. I also believe that the comments of the members of the project advisory committee raise questions of substance which should be but are not considered adequately in the study. I have appended my comments and observations on some aspects of the study following the comments of members of the project advisory committee.

In spite of my reservations, I find non-publication of the study less attractive than publication. First, I believe that publishing the comments of the members of the project advisory committee compensates for many of the study's deficiencies. Second, the problems treated by the study are pressing and I expect it to accomplish one of its purposes, namely, to stimulate discussion in the accounting profession and the business community which will help the Accounting Principles Board in dealing with those problems. If this discussion is to be most useful to the Board, however, readers must read carefully both the study and the comments and focus attention on issues, premises, arguments, and evidence rather than on conclusions alone. The resulting discussion will then justify publication of the study.

New York, N. Y., August 1968

Reed K. Storey
Director of Accounting Research

Authors' Preface

The concept of business goodwill value—defined in this study as the difference between the total value of an enterprise and the aggregate value of its separable resources and property rights, less liabilities—has existed for a long time and much has been written on the subject. However, the proper accounting for goodwill remains one of the most controversial issues in the field of accounting, and the differences in views which exist today are remarkably similar to those which have been expressed over many years.

The total value of a business enterprise, including its goodwill value, is generally not dealt with in accounting except in connection with events involving significant changes in ownership interests in a business enterprise. Such changes arise most often in today's environment when a business combination occurs and one business enterprise gains control over another. Thus, the principal problem of accounting for goodwill (and the one on which this study focuses) relates to the broader problem of accounting for business combinations.

Accounting Research Study No. 5, "A Critical Study of Accounting for Business Combinations" by Arthur R. Wyatt, was published by the Director of Accounting Research of the American Institute of Certified Public Accountants in 1963. That study dealt primarily with the pooling of interests method of accounting for business combinations and addressed itself to the propriety of the two alternative approaches to accounting for business combinations—pooling of interests and purchase accounting. The specific question of accounting for goodwill was outside the general scope of *Accounting Research Study No. 5*.

Any extensive consideration of the conclusions of *Accounting Research Study No. 5* by the Accounting Principles Board probably would not have been fruitful unless the question of accounting for goodwill was first examined. Accordingly, the Director of Accounting Research authorized this study of accounting for goodwill.

Since the resolution of the problems dealt with by Wyatt affects the dimensions of the problem of accounting ıor goodwill, we have also given consideration to the results of *Accounting Research Study No. 5*. Thus, the conclusions of this study not only encompass the problem of accounting for goodwill, but also express our views on the conclusions reached in *Accounting Research Study No. 5* (with which they are in basic agreement), in an attempt to present a coordinated set of recommendations relating to the entire problem of accounting for business combinations.

In making this study, we have endeavored to seek solutions to the problems of accounting for goodwill and business combinations which are in accord with the objectives of financial statements and which are as consistent as possible with existing conventions and concepts used in accounting to meet those objectives. In the absence of authoritative definitions by the accounting profession as to the objectives of financial statements and the broad underlying principles necessary to accomplish those objectives, we have set forth our own views on these matters and evolved various criteria or guides for use in considering the problem of accounting for goodwill. From an examination of the nature and valuation of goodwill, certain characteristics were identified as distinguishing goodwill from other elements of value in a business. The financial statement criteria or guides, together with the distinguishing characteristics of goodwill, form the bases upon which we have developed and tested our conclusions.

While the recommendations of this study would represent a significant departure from the accounting practices which now exist in this area, we believe that the recommended procedures would achieve results which (a) are more in harmony with the true purposes and objectives of financial statements and (b) are more consistent with existing accounting principles in other areas than are the present practices. We wish to emphasize that we have not attempted to prescribe a new general framework or basis of accounting.

Reed K. Storey, the Director of Accounting Research of the American Institute of Certified Public Accountants, his associates, and the members of the project advistory committee have provided valuable counsel and assistance over the course of the study. The members of the project advisory committee are: Leonard Spacek, Chairman, Charles F. Axelson, Donald J. Bevis, Philip L. Defliese, Homer Kripke, William A. Paton, and J. S. Seidman. Their comments are also presented.

We are also indebted to many others, including our professional associates, Milton H. Fortson, Willis A. Leonhardi, Paul M. Marquart, and Arthur R. Wyatt, for their help.

The Director of Accounting Research in his Statement and Comments included herein is critical of the general approach taken in this study. His views in this regard were carefully considered while this study was in process. We believe that accounting research has too often been directed to the past (and consequently overly influenced by all of the inhibitions, conventions, and customs which have given rise to the problems in the first place) rather than to the real needs of the users of financial statements in the future. Also, we believe that in seeking solutions to difficult problems, research which is limited to the traditional fact-finding and dispassionate evaluation of all possible alternatives is not a substitute for new and creative thought. In this study, we *are* advocating solutions which we consider to be sound in the light of our view of the objectives toward which the accounting profession should be working.

The present wide scope and extensive nature of acquisitions, mergers, and consolidations in the business community make it more urgent than ever that solutions be found to the problems described in this study. The accounting for business combinations may have an impact on the interests of millions of individual stockholders and creditors in American business and may determine, in part, whether business expansion takes a course which achieves the most desirable economic results for our country and its people.

Chicago, Ill., August 1968

GEORGE R. CATLETT
and
NORMAN O. OLSON

1

Introduction

The Broad Problem—Accounting for Business Combinations

Business acquisitions, mergers, and consolidations are an everyday occurrence in the modern business world. These transactions, referred to in this study by the broad term "business combinations," result from a variety of factors, including needs for expanding or diversifying a business enterprise, efforts to strengthen management, income tax and estate tax problems of the owners of the selling or absorbed company, and many other competitive and financial considerations. The ultimate goal of the combination, for the business enterprise which survives or arises from the transaction, is to improve the effectiveness of the operations of the combined enterprise and, thus, to increase its earnings.

Importance of Accounting for Business Combinations. The accounting for a proposed business combination becomes important before the transaction is consummated. The individuals whose ownership interests are involved must have proper financial information to decide to approve or oppose a particular transaction. Those who would become stockholders in the continuing or resulting enterprise should have information to decide to sell or retain their investments. Stockholders make decisions of this nature primarily by comparing their investments with other investment opportunities. Inadequate or misleading accounting for business combinations may give stockholders an erroneous impression about the basis of trading their ownership interests and may increase the possibility (a) that combinations will occur which are not economically sound or (b) that combinations which are economically sound will not occur.

Of equal importance is the effect which the accounting practices for a business combination have on financial position and earnings reported in subsequent years and on the comparability of data among business enterprises. The practices bear directly on the amount of net income reported by the resultant enterprise and on the financial position, including the amount of stockholders' investment, shown in its financial statements.

Principal Questions. Accounting for business combinations presently encompasses two alternatives which are acceptable for most combinations effected by voting stock, while only one of the alternatives is acceptable for combinations effected by cash or other property. The two alternatives do not result in accounting for the same values and raise numerous questions of financial presentation and earnings determination.

2 The broad problem of accounting for business combinations includes these principal questions:

1. Is a business combination effected by stock a basically different kind of transaction from a combination effected by cash or other property, thereby requiring a fundamentally different accounting treatment?
2. What is the total amount to be accounted for in recording a business combination?
3. How is the total amount to be accounted for by the resultant enterprise? What dispositions should be made of this amount?

Current Practices in Accounting for Business Combinations

Accounting practices considered acceptable today include two radically different concepts of accounting for business combinations. These concepts are known as purchase accounting and pooling of interests accounting. In addition, various acceptable alternative methods exist for applying purchase accounting to a business combination. The various practices are discussed in more detail in subsequent chapters, but a brief description of the present situation is presented below.

Purchase Accounting. Under purchase accounting, generally considered an acceptable method of accounting for all business combinations (including those which would qualify for pooling of interests accounting), the separable resources and property rights and liabilities of the acquired company are recorded as assets and liabilities of the acquiring or continuing company at their fair values at the date of the combination. The difference between the total value of the consideration given and the fair values assigned to the separable resources and property rights, less the liabilities—ordinarily referred to as goodwill—is also recorded as an asset of the continuing company.

Goodwill with unlimited life is carried as an asset without amortization or alternatively is amortized to income over an arbitrary number of years. Goodwill which, initially or in subsequent years, is recognized to have limited life is amortized to income (before extraordinary items) over this life, or it may be written off or written down as an extraordinary item if the loss of value is due to unusual events or developments during the period and the amount of the loss is material.[1]

The amount recognized as goodwill has a rather elusive nature. Commonly it is a residual, the amount remaining from the total price paid after allocating fair values to the several separable resources and property rights and liabilities. Questions have been raised as to whether goodwill can be identified as having either a measurable limited life or an unlimited life. In any event, making any distinctions concerning the life of goodwill has been difficult. As a result, alternative practices of accounting for goodwill have been applied in similar situations.

Pooling of Interests Accounting. Over the last decade, pooling of interests accounting has become increasingly popular and is now considered an acceptable alternative to purchase accounting for almost all business combinations effected by issuing common or voting stock. Under the pooling of interests concept of accounting, the business combination is not viewed as a purchase of one company by another

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[1] *Opinion No. 9* issued by the Accounting Principles Board in December 1966 sets forth criteria for distinguishing items which are to be recognized as extraordinary items in the determination of net income and items which are to be considered as prior year adjustments to be charged to retained earnings. Goodwill amounts which previously would have been charged to retained earnings under the provisions of Chapter 5 of *ARB 43* would now be classified as extraordinary items under the criteria established in *APB Opinion No. 9*.

but as a joining or "marriage" of the constituents. The amounts at which assets and liabilities are recorded in the accounts of the predecessor companies are carried forward in the accounts of the continuing or resulting business enterprise. Pooling of interests accounting does not recognize either the fair value of the individual separable resources and property rights of the acquired or absorbed business or the value of its goodwill.

Pooling of interests accounting accelerated with the issuance in 1957 of *Accounting Research Bulletin No. 48*, which provided greater endorsement of this accounting than had previously existed. The increased usage of pooling of interests accounting can also be traced to the difficulties of accounting for goodwill under existing concepts and to the unpopularity of purchase accounting in a period of rising stock market prices. The difficulties of associating goodwill value with a specific time period for amortization on any basis other than an arbitrary one were noted above. Since amortization also resulted in a charge against earnings (a charge not deductible for income tax purposes) and thereby reduced reported profits, a policy of amortization proved unpopular. A policy of nonamortization meant that the goodwill value remained as an asset, but apparently this asset had little, if any, significance in evaluating a company's financial position. Under these conditions, the pooling of interests method provided a convenient and useful solution to the problem of what to do with goodwill—omit any recognition of goodwill and thereby forestall the need to solve a problem for which none of the available alternative solutions was desirable in an accounting or business sense.

Accounting Research Study No. 5

The Director of Accounting Research of the American Institute of Certified Public Accountants (AICPA) published in June 1963, *Accounting Research Study No. 5* (*ARS 5*), "A Critical Study of Accounting for Business Combinations," by Arthur R. Wyatt. That study dealt primarily with the pooling of interests method of accounting and addressed itself principally to the first of the three questions listed above. The scope of *ARS 5* is discussed and the conclusions are summarized in Appendix A to this study.

Wyatt concluded in *ARS 5* that substantially all business combinations today are exchange transactions between independent parties and involve the transfer of assets between business enterprises. He contended that the usual principles of accounting for the purchase of assets should be applied to business combinations and that the pooling of interests method should not be employed unless the business combination was not an arm's-length transaction between independent parties. A few transactions result in a new enterprise as compared to a continuing enterprise, and Wyatt suggested that under such conditions all of the assets of the resultant enterprise should be accounted for at their fair value at the date of the combination.

Various members of the project advisory committee for *ARS 5*, as well as the AICPA's Director of Accounting Research, disagreed with some conclusions of Wyatt. Supplemental comments by Robert C. Holsen (see pages 172 to 173) reaching a somewhat different general conclusion were included as an addendum to the study. Some persons commenting on the study contended that the problem of accounting for goodwill must be examined before Wyatt's conclusions could be considered and evaluated. Accounting for goodwill was outside the general scope of Wyatt's study, and accordingly he did not consider that subject extensively.

Scope and Purpose of This Study

The accounting for a particular business enterprise ordinarily does not recognize the total value of the enterprise, and it is not the purpose of accounting to determine or measure that value. Accounting and the resulting financial statements present information about financial position and results of operations (including net income) which, with innumerable other factors affecting investor decisions, enter into the investors' determination of the value of a business enterprise—as evidenced by the market price of its stock. Consequently, only by coincidence does the total value of an enterprise equal the total amount of net assets shown in its balance sheet.

Only when a business combination occurs and one business enterprise acquires or gains control over another does accounting deal with the total value of an enterprise as it is valued in the marketplace—and then only if that transaction is accounted for as a purchase. The values of both the acquiring (continuing) and acquired (absorbed) business enterprises may be considered by the parties in arriving at the terms of a business combination, but the value of the acquired business is the only one considered in the accounting of the resultant enterprise.

The disposition of the difference between (a) the total current value of the enterprise acquired and (b) the total current value of the separable resources and property rights less liabilities of that enterprise presents the greatest difficulty in accounting for business combinations. How should this difference—purchased goodwill—be accounted for in the financial statements of the continuing enterprise which survives or results from the combination?

The purpose of this research study is (a) to analyze the nature of goodwill, (b) to consider various alternative practices in accounting for goodwill, and (c) to determine the most reasonable solution to the related accounting problems. The study evaluates current practices in accounting for nonpurchased goodwill (goodwill developed by an enterprise), but it relates primarily to accounting for goodwill as a part of the broader problem of accounting for business combinations.

The results of *ARS 5* have been considered in this study, since resolution of the problems dealt with in *ARS 5* greatly affects the extent to which the problem of accounting for goodwill arises. Thus, this study represents an extension of *ARS 5*, and the conclusions reached in the two studies should provide a basis for discussion by the Accounting Principles Board in its consideration of an Opinion on accounting for business combinations and goodwill.

The term "business combination" is used in this study in the same broad sense as it was used by Wyatt, as ". . . any transaction whereby one economic unit obtains control over the assets and properties of another economic unit, regardless of the legal avenue by which such control is obtained and regardless of the resultant form of the economic unit emerging from the combination transaction."[2] Under this definition, business combinations include a variety of transactions referred to by various names, such as acquisitions, mergers, and consolidations. Business combinations may be effected by means of cash, notes, bonds, common stock, preferred stock, or other property. Business combinations, as referred to in this study, are arm's-length transactions between independent parties unless otherwise indicated. Thus, the legal or statutory merger of commonly held (or parent-subsidiary) enterprises is not a business combination as that term is used in this study.

This study does not consider the accounting for intercorporate investments, which is the subject of another research study.

When solutions are sought for difficult accounting problems without first agreeing on the premises and concepts to be used as criteria and guides, the results represent temporary and isolated measures that will not meet the needs of our society in the area of financial accounting.

[2] *Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations," 1963, p. 12.

Since the accounting profession has not yet defined authoritatively the purpose or objectives of financial statements, the authors of this study have set forth their views of such objectives and have identified certain other premises and concepts which are necessary prerequisites to arrive at a suggested solution to the problems covered by this study. Readers of this study may disagree with the premises and concepts or with the reasoning from the base points to the suggested solution. However, a clear distinction must be made between the desirability and adequacy *of* the base points and the logic of the reasoning *from* the base points; otherwise, most of the advantages of this study will be lost.

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Nature and Valuation of Goodwill

General Background

8 Goodwill, in its broadest sense, is defined in Webster's *Third New International Dictionary* as "kindly feeling: well-wishing, benevolence, friendliness." The second definition is: "the custom of a trade or business: the favor or advantage in the way of custom that a business has acquired beyond the mere value of what it sells whether due to the personality of those conducting it, the nature of its location, its reputation for skill or promptitude, or any other circumstance incidental to the business and tending to make it permanent." The third definition states that goodwill is: "the capitalized value of the excess of estimated future profits of a business over the rate of return on capital considered normal in the related industry." And the fourth definition is: "the excess of the purchase price of a business over and above the value assigned to its net assets exclusive of goodwill."

The idea of goodwill appears to have existed long before the advent of modern business concepts. P. D. Leake mentions some early references to goodwill, including one in the year 1571 in England, "I gyve to John Stephen . . . my whole interest and good will of my Quarrell (i.e. quarry)."[1]

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[1] "Goodwill: Its Nature and How to Value It," *The Accountant*, January 17, 1914, p. 81.

The nature of goodwill, the characteristics which distinguish it from the separable resources and property rights of a business, and its treatment in the accounts are among the most difficult and controversial subjects in accounting. John B. Canning stated, "Accountants, writers on accounting, economists, engineers, and the courts, have all tried their hands at defining goodwill, at discussing its nature, and at proposing means of valuing it. The most striking characteristic of this immense amount of writing is the number and variety of disagreements reached."[2]

The value of goodwill is closely related to the value of other intangibles of a business enterprise, and the line which divides values attributable to goodwill from those attributable to other intangibles is not always clear. Complex questions of valuation exist for all intangibles, but businessmen resolve them every day in the purchase and sale of specific intangible rights such as patents. While the accounting for all intangibles may be a subject for further study, this discussion assumes that the values of separable intangible property rights can be isolated and segregated from the value of goodwill.

The purpose of this chapter is to examine (a) the changing concepts of the nature of goodwill, (b) the factors which determine the value of goodwill, and (c) the characteristics which distinguish goodwill from the individual separable resources and property rights of a business. The evolution of the accounting practices relating to goodwill is discussed in Chapter 4.

Changing Concepts of Goodwill

Early Concepts of Goodwill. The general concept of goodwill has changed considerably over the past century. The concept today is much broader and encompasses many more intangible economic factors of a business enterprise than the simpler concept of earlier years.

The goodwill of a business was initially perceived as consisting mainly of good and advantageous relations of a proprietor of a business with customers. These relationships represented the principal advantages which one business might enjoy over another in the relatively simple establishments of the day. J. M. Yang refers to a case in 1810 where the benefit of a certain convenient location and the habit of the customers to resort to it were considered as the essential ele-

[2] *The Economics of Accountancy,* 1929, p. 38.

ments of goodwill when Lord Eldon (in Cruttwell v. Lye, 17 Ves. 335, 346) ruled "The goodwill which has been the subject of sale, is nothing more than the probability that the old customer will resort to the old place."[3]

The prize-winning paper in a student-essay competition sponsored by the Liverpool Chartered Accountants Students' Association in 1888 defined goodwill as:

> . . . the benefit and advantage accruing to an existing business from the regard that its customers entertain towards it, and from the likelihood of their continued patronage and support. Hence, it has no relation to a new business, and is only applicable to one already established.[4]

In the simpler business organizations of the earlier period, goodwill was often of a rather personal nature, attaching in large measure to the particular personality, friendliness, and skill of the proprietor or partners of a business. Much of what was written on the subject around the turn of the century, notably by English accountants, involved valuing goodwill on the death or withdrawal of a partner in the business. A particular concern was the part of the goodwill of the business that was lost with the loss of a proprietor or partner.

> Coming next to the case of a person acquiring the Goodwill of a business from a person who proposes to retire therefrom, it will be obvious that the principal question which the purchaser will ask himself is as to how far, if at all, he will really step into the shoes of the vendor; and it is according to the probabilities of his actually so doing that he will be prepared to pay more or less for the Goodwill which is supposed to be conveyed to him.[5]

As the industrial system developed and business increased in complexity, the various advantages which a business possessed and which contributed to its profitability became less personal in nature. The individual advantages which a company enjoyed became more varied, were integrated with all facets and activities of a business, and thus became less distinguishable. Manufacturing processes, financial connections, and technological advantages all assumed increasing importance. Goodwill came to be regarded as everything that might contribute to the advantage which an established business possessed over a business to be started anew.[6] However, even that concept is

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[3] *Goodwill and Other Intangibles,* 1927, p. 28.

[4] J. H. Bourne, "Goodwill," *The Accountant,* September 22, 1888, p. 604.

[5] Lawrence R. Dicksee, "Goodwill and its Treatment in Accounts," *The Accountant,* January 9, 1897, p. 41.

[6] J. M. Yang, *Goodwill and Other Intangibles,* 1927, p. 29.

too narrow for the dynamic attributes of goodwill in modern business, since the market value of stocks sometimes indicates that investors ascribe large amounts of goodwill value to relatively new business enterprises.

Concept That Goodwill Relates to Earning Power. Paton and Paton stated, "Originally restricted to the worth of an established clientele, the term 'goodwill' has come to be applied to that portion of the value of the enterprise which may be attributed to the entire range of advantageous connections—commercial, industrial, financial, and political."[7] Yang attempted to describe goodwill as consisting of three broad classes of economic advantage: (a) "consumer's goodwill" or the "habitual or preferential patronage of customers"; (b) "industrial goodwill," or "the loyalty and adaptability of employees"; and (c) "financial goodwill," or a "credit standing which will facilitate the raising of funds when needed."[8]

Both the Patons and Yang recognized, however, that such characterizations of goodwill were too narrow. They acknowledged as a more useful concept one which had been recognized to a considerable degree by some earlier writers and somewhat hesitatingly by the courts, but one which was receiving wider acceptance. Under this concept goodwill included virtually all of the "factors and conditions which contribute to or accompany unusual earning capacity."[9]

George T. Walker stressed what he saw as the relationship between goodwill value and an above-normal earning capacity:

> By definition, goodwill has no accounting significance except in terms of an earning capacity which is estimated to be above normal. A price is paid for goodwill—a price above the value placed on the other assets—because profits in excess of a normal return on the investment are anticipated. In other words, an enterprise is purchased, not primarily as a means of securing a group of assets, but as a means of securing a stream of income in the future. If the expected stream of income is a normal amount or at a normal rate, all factors considered, no payment is likely to be made for goodwill. If the expected income stream is in excess of normal earnings, a payment will probably have to be made for goodwill. Then, it may be said that the payment for the expected stream of income in excess of a normal return is a pay-

[7] William A. Paton and William A. Paton, Jr., *Asset Accounting,* 1952, p. 488.

[8] *Op. cit.,* pp. 41-56 and p. 87.

[9] Yang, *op. cit.,* p. 87.

ment for goodwill, and that the payment for the expected stream of income equal to a normal return is a payment for the other assets.[10]

The earning power concept of goodwill recognizes that the several intangible attributes which in the aggregate are favorable to a business as a whole contribute to its goodwill. None of the attributes appears susceptible to individual measurement comparable to that which can be applied to the separable resources and property rights of a business, values of which exist apart from the business as a whole. The existence and quality of the aggregate of intangible attributes of a business can be demonstrated only by a company's ability to make profits. These attributes will sustain values only if investors believe that future profits will be sufficient to support a value for the business as a whole over and above the total value of its separable resources and property rights.[11]

In today's business environment the earning power concept of goodwill is the most relevant. The sales and purchases of business enterprises as a whole are motivated primarily by the expectation of future profits. Further, the value established for a business in a sale-purchase transaction reflects evaluations as to the earning power of the business. To the extent the value of the business as a whole exceeds the value of its separable resources and property rights, the earning power of the business evident in the transaction must relate to other attributes. Goodwill thereby becomes associated with the variety of interrelated intangible attributes which in the aggregate derive value from an evaluation of future earning potentialities of the business enterprise.

The earning power concept of goodwill suggests that the goodwill of a business may be different in nature from the other elements in the value of a business in that goodwill is not separable in the sense of being salable apart from the business as a whole. This distinction suggests that determining the value of goodwill generally involves an evaluation of the business as a whole, and that it may not be appropriate or fruitful to attempt to determine a value for goodwill in a manner similar to that for a plant. Goodwill appears to be an integral part of the business unit, without an identifiable existence apart from the business.

[10] "Why Purchased Goodwill Should Be Amortized on a Systematic Basis," *Journal of Accountancy*, February 1953, p. 213.

[11] The word "value" is used throughout this study in the sense of reasonable approximation of current worth in use or exchange, arrived at by whatever valuation approach is most appropriate under the circumstances.

Value of Goodwill

A value can be established for most assets by determining the price a willing buyer would pay or a willing seller would take for the asset. If goodwill exists only as a value which attaches to the business as a whole, this approach to direct valuation of goodwill is not possible, and other measures of its value must be found. In general, the value of goodwill can be measured indirectly by determining (a) the overall value of a business enterprise and (b) the net values of the various separable resources and property rights. If the overall value of the business exceeds the sum of the values of the separable resources and property rights, the excess must represent the value, in the aggregate, of all other attributes of the business which make it more valuable as a unit than the sum of the identifiable resources.

The overall value of a business may be determined by a number of different methods. For businesses whose stock is publicly traded, a value for goodwill can be determined on a daily basis by reference to the price of the stock in the marketplace. Market price provides one basis to determine the total value of the business and, therefore, a basis for the valuation of goodwill, since the values of the separable resources and property rights may be determined directly. A value for goodwill determined in this way may need to be modified if the market price of the stock has resulted from artificial or unusual market conditions and is subject to defects in the values determined for the separable resources and property rights. On the other hand, the value of the stock of a business in the marketplace reflects some consensus of evaluations of future earning power.

Other means of measurement are possible, many involving the use of discounting and other mathematical concepts. Under a discounting method, expected future profits are projected for a period of future years and are discounted at an appropriate rate of interest to determine the present value of the expected future profits. That value represents an approximation of the total current value of the business. Since the net value of the separable resources and property rights can also be approximated, a value for goodwill is determinable. A discounting method is subject to whatever defects may be inherent in future projections generally, as well as those that may exist in a subjective projection of future profits and in the selection of a rate of interest for discounting purposes. Further, the accuracy of the projections is dependent on the capabilities of the individual or individuals making them and does not embody a consensus view similar to that of the market value approach.

To estimate the value of goodwill for a business whose stock is not traded publicly, attention would be directed primarily to the earning power of the business, since goodwill by nature encompasses all those intangible attributes of a business whose quality can be demonstrated only by a company's ability to make profits.

Value of Goodwill Determined by Investor. One can determine the total value of a business whose stock is publicly traded, and therefore its goodwill, by the market price of the stock. Market value may change daily for a variety of reasons, but for an individual investor the market price provides a basis for his decision on whether to buy (at a price including a goodwill element), hold, or sell (and thereby receive payment for a goodwill element). A number of variables affects the decisions of investors, but their evaluations of the estimated earnings of the business and the relationship of earnings to the level of return on investment desired are controlling factors in their decisions and are reflected in the market price of the stock. The market price of the stock of a business represents, in effect, a composite opinion of many investors as to the quality of a business' earning power.

Both the potential *amount* of future earnings and the *degree of risk* involved in achieving that amount affect the amount that an investor is willing to pay for ownership interests in a business. If he considered that his risks are no greater than those of the prior claims of a creditor, he would discount future profits for an ordinary interest factor. J. E. Sands has stated:

> The greater the likelihood that forecast wealth will not be realized, the less they are willing to pay for a chance for it. The greater the likelihood that forecast wealth will be realized, the more they are willing to pay for a chance for it. And if they could be certain what the future wealth of a business would be, they would be willing to trade their present wealth for that future wealth at a rate of discount determined only by their preference for present over future wealth.[12]

Investors' opinions of the goodwill of a business today may be influenced by many types of information and may or may not be based on reliable financial information, depending on (a) the depth of study of the company's financial statements, (b) the soundness of the information conveyed by those statements, and (c) the availability of other data. Some historical financial information may be a minor factor in shaping investors' opinions.

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[12] *Wealth, Income, and Intangibles,* 1963, p. 79.

The views of investors may also be influenced by the public image of a company. The image may have been created by the specific efforts and expenditures of a company, or it may have resulted from other forces that mold public opinion. Investors' opinions may reflect public reactions to the possible influence of wars, strikes, or major political events on a particular company's future or on a nation's economy. Events such as a serious business failure, a strike, the threat of a war, or the assassination of a President have resulted in sudden and drastic changes in goodwill values—values which were later adjusted as investor attitudes on the consequences of the event changed; furthermore, the value also depends on investors' speculations as to the attitudes, views, and reactions of other investors.

Goodwill may exist where none appears to be justified in terms of historical profit performance because the value is based on investors' beliefs, expectations, and speculations about the future. The courts have observed goodwill even in bankrupt concerns.[13]

If an investor believes that the obstacles which prohibit an above normal return can be removed and that future earnings will be greater, the value of existing goodwill is determined on the basis of his valuation of the expected future earnings. Kester commented on this point in a discussion of what he called "dormant" or "latent" goodwill:

> Dormant or latent goodwill signifies the excess earning power that would exist if it were not for poor management, an inharmonious working together of the various parts of the organization, and other similar handicaps which the new management will remove. It may be objected that until such handicaps have been removed there is no goodwill; that any goodwill brought into evidence through the removal of these handicaps is the goodwill built up by the new concern and not the old. It cannot be denied, however, that all the other elements of goodwill may have been acquired and built up by the old company and that without them the new concern would be unable to bring goodwill into evidence simply by a change of management.[14]

The magnitude of the changes in attitudes toward business enterprise values is dramatized by the goodwill now attributed to some companies in the early stages of their development—with no earnings record yet established. The goodwill value undoubtedly reflects a whole range of attitudes and reactions to the dramatic and spectacular

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[13] James C. Bonbright, *The Valuation of Property,* Volume II, 1937, pp. 755-756.

[14] Roy B. Kester, *Advanced Accounting,* Fourth Edition, 1946, p. 354; see also Henry Rand Hatfield, *Accounting,* 1927, p. 122.

future influences of science. This situation has existed in the last decade in many relatively new industries, particularly in "glamour" areas such as electronic computers, atomic energy, satellites, rockets, television, photography, and other areas with rapid technological developments.

Capitalization of Earnings. The various bases on which investors decide whether to buy, hold, or sell are difficult to identify. However, an informed investor is influenced, in part at least, by comparing the anticipated return determined by his analyses with some predetermined standard of return. Even for a company whose securities are listed on a stock exchange and are widely traded, this comparison involves capitalizing earnings. Expected future earnings for a selected period are capitalized at a rate of return considered reasonable or appropriate after assessing all of the risks and circumstances. Commonly, no distinction is made between the value of "normal" and "excess" earnings. The capitalized earnings may then be compared with the market price of the stock as a basis for a buy-hold-sell decision.

The same method may be followed, of course, whether the investor is a small shareholder facing a decision to acquire, hold, or sell 10 or 100 shares or a business facing a decision concerning a business unit as a whole. If either transaction occurs, the value of goodwill can be determined by deducting from the agreed price the net value of all separable resources and property rights.

Earnings may be capitalized by alternative methods, but the observations in the preceding paragraphs apply equally under the alternative methods. For example, a "normal" return can be computed on the value of the net assets other than goodwill, and the estimated future earnings in excess of the "normal" return can be capitalized at a higher rate of return to arrive at a valuation for goodwill. A higher capitalization rate on the "excess" earnings is justified in the valuation of goodwill on the grounds of its uncertainty, the inability to divorce it from the business as a whole, and because of the fluctuations in its value.[15] Henry Rand Hatfield stated that the larger the excess earnings are over normal earnings, the higher the capitalization rate should be.[16] The capitalization of future earnings is sometimes broken down into "layers" of life expectancy at present value based on predetermined discount rates. Stratification, or differentiation of earnings into

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[15] Harry Simons and Wilbert E. Karrenbrock, *Intermediate Accounting*, Fourth Edition, 1964, p. 520.

[16] *Accounting*, 1927, p. 122.

"layers," is supported on the theory that extremely high earnings are fragile, likely to attract competition, and are therefore of relatively short duration.[17]

Significance of Goodwill Value to Accounting. The value of the goodwill of the business indicated by the market price of its stock has no accounting significance for that business enterprise unless the business is a part of an exchange transaction providing the basis for the goodwill valuation. However, for the investor who buys its shares, goodwill has accounting significance since his investment cost represents an interest in all the separable resources and property rights of the business plus an interest in any goodwill value indicated by the market price.

Goodwill value has an even greater accounting significance in a business combination, since a business enterprise becomes the investor and the total goodwill of another business is involved in the transaction. Because of the significance of the business combination to investors in the constituent businesses, the residual value assigned to goodwill in a combination is more relevant than the goodwill value computed from the market price of the stock prior to the decision to sell the business as a whole. In effect, the transaction validates a goodwill value for the business, a value that results from negotiations between the buyer and the seller.

Factors Contributing to Earning Power. In view of the relationship of goodwill to earning power, a listing of some of the possible advantageous factors and conditions which a company might have and which could give rise to superior earning power may reveal some additional characteristics of goodwill. Identification of the characteristics should be helpful in determining the proper accounting for goodwill.

Advantageous factors and conditions which could contribute to a company's earning power include:

1. Superior management team
2. Outstanding sales manager or organization
3. Weakness in the management of a competitor
4. Effective advertising
5. Secret manufacturing process

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[17] Maurice Moonitz and Louis H. Jordan, *Accounting: An Analysis of Its Problems,* Volume One, Revised Edition, 1963, p. 512.

6. Good labor relations
7. Outstanding credit rating resulting from an established reputation for integrity (thereby providing a company extra equity "leverage" through more than ordinary borrowings at favorable interest rates)
8. Top-flight training program for employees
9. High standing in a community through contributions to charitable activities and participation in civic activities by a company's officers
10. Unfavorable developments in operations of a competitor
11. Favorable association with another company
12. Strategic location
13. Discovery of talents or resources
14. Favorable tax conditions
15. Favorable government regulation.

This is a random listing of a few of the many factors which could contribute to the earning power of a company. No list of all or nearly all the factors and conditions contributing to goodwill is possible, a fact which is itself indicative of the nature of goodwill. Likewise, any generalization about goodwill is difficult because of the diversity of the several factors and conditions, but some characteristics are evident.

The intangible nature of each factor is readily apparent. A business may be able to exert control over some of the factors, but many others arise from fortuitous events largely or wholly beyond the control of management. Management may incur a cost in connection with some factors, whereas others emerge in the absence of incurred cost or managerial effort. Furthermore, the resultant value of factors for which costs may be incurred commonly bears no reasonable relation to their costs of development. The existence of one or more factors or conditions supporting a goodwill value can frequently be identified, but measuring their individual values is impracticable.

In a business combination, the value attributable to goodwill relates to the aggregate of the factors and conditions which have contributed to the goodwill element of the business. The basic nature of the factors and conditions, as well as the manner in which they are interrelated and in which they are related to the business as a whole, makes it impossible to determine a value for each factor separately. Goodwill has no value except as an integral part of the business, and the values of the several factors contributing to goodwill are not susceptible to measurement on a separate or individual basis.

The list of factors and conditions on pages 17 to 18 does not encompass *all* intangibles. Some intangible assets represent separable resources and property rights; for example, patents, copyrights, leaseholds. This study assumes that the values of certain intangibles can be isolated and measured and that those identifiable values are not properly a part of goodwill. Goodwill represents the intangible value which has resulted from the several factors and conditions that have evolved as an integral part of the business.

Goodwill as an Asset of the Owners of a Business Enterprise. Recognition that goodwill value exists only to the extent that investors or owners ascribe it to a business has led to the recent concept that goodwill is an asset of the owners of a business entity rather than of the business entity itself. This viewpoint was expressed by Raymond J. Chambers:

> ... the goodwill of a going concern runs to the constituents, not to the firm. It is they who put valuations on expected superior returns. It is they who have the right to dispose of going concerns or of their interests in them. To regard goodwill as an asset of a going concern is to confuse two entities—the constituents as persons and the firm as an instrument. If the constituents accept an offer for a going concern in excess of the current cash equivalent of its capital, the difference is simply a gain to them. It arises only when the firm *ceases* to be the same firm by becoming the instrument of a new group of constituents. The new constituents, having laid out a sum in excess of the current cash equivalent of the old firm's components, may regard the advantage acquired as an asset of the new firm. But this excess, though represented by a money payment, is no different from the amount by which the subjective valuation of any single asset exceeds the price paid for it; and no such excess is regarded as part of the current cash equivalent of an asset. That cash has been paid may be recognized in the record; but its effect is in no way to increase the adaptability of the firm, and the indicated treatment of it is to reduce the amount of the residual equity from the price paid to the current cash equivalent of the new firm's component assets and liabilities.[18]

Chambers states that goodwill is relevant only to those selling or disposing of their interests in a going concern and is a receipt now of anticipated superior future returns of the concern. To the purchaser goodwill is not an income-producing asset, but rather is an advance

[18] *Accounting, Evaluation and Economic Behavior,* 1966, p. 211.

distribution of anticipated future earnings. Thus, Chambers concludes that goodwill is properly a reduction of shareholders' equity.

Summary of Characteristics of Goodwill

Certain characteristics which generally distinguish goodwill from other elements of value in a business can be identified in a general way. These characteristics are summarized below.

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.

Whether or not investors' opinions reflected in the market price of stock represent a sound view of future earnings prospects, the market price of stock provides the basis for measuring the amount which investors attribute to the goodwill of a business at a date. When one business acquires or absorbs another, the goodwill value determined by the investor presents an accounting problem. The goodwill which poses the accounting problem is that related to some *other* business unit which is being acquired or absorbed—a goodwill whose value may be greatly affected by the dynamics of the business combination itself and whose value then loses its identity as the investor now contemplates the earning power of the continuing business enterprise on a combined basis.

3

Financial Statement Objectives and Accounting Conventions and Concepts

Financial Statement Objectives

To provide a basis for reaching conclusions on the most appropriate method of accounting for goodwill under present conditions, a brief consideration of current financial statement objectives and accounting conventions and concepts is appropriate. The discussion in this chapter is in no way an attempt to set forth or prescribe a revised framework for accounting; rather it presents the authors' evaluation of the objectives, conventions, and concepts which appear to exist in today's business and investment environment. Hopefully, a solution to the goodwill problem can be developed which will help produce the most useful and meaningful financial statements and which will, at the same time, be consistent with existing broad accounting conventions and concepts.

A solution to the problem of accounting for goodwill involves the same dilemma which exists in many attempts to achieve progress in accounting. The dilemma is that the whole structure of accounting principles and practices cannot be changed at once because of the magnitude of the undertaking. The close interrelation of accounting principles and practices makes improving one area of accounting difficult because the changed area would then be inconsistent with other, unchanged areas.

As discussed in Chapter 2, the nature and concepts of goodwill have changed over the years. The uses and objectives of financial statements and practices in accounting for goodwill, as discussed in Chapter 4, have also changed. At least some of the reasons underlying the changes in accounting for goodwill as well as in other accounting practices are changing uses and objectives of financial statements.

Usefulness and Comparability. Financial statements provide information concerning business enterprises. The usefulness of the information provided rests in part on the soundness of the various accounting practices employed to produce the information. Thus, the solutions to individual accounting problems should be sought in terms of the uses and objectives of financial statements.

Accounting interest centers around individual business entities which generally have a continuity of existence extending over many fiscal periods. The ownership interests (shares of stock) in individual business entities frequently change daily at varying prices. Decisions by stockholders as to their ownership interests reflect their evaluations of many variables, including available financial information about the business entity. The primary purpose of accounting in providing public information regarding a business enterprise is to supply information which (a) investors can use to make decisions as to buying, selling, or retaining ownership interests in the business, (b) creditors can use to make decisions concerning the terms for extending credit to the enterprise, and (c) others can use for appropriate purposes.

The decisions of investors and creditors involve the process of choice. Investors, for example, choose to buy or sell the shares of one business enterprise rather than the shares of numerous other enterprises. Therefore, the financial information about a business will be useful to investors and creditors only if that information provides a basis for comparing the performance of that business with others.

The question which must be answered is—*what* financial information is significant or important to those who use the information as a basis for their judgments and actions? To answer this question, the purpose and results of business activity must first be considered.

Purpose and Results of Business Activity. In the simplest terms, business activity involves the production and distribution of goods and services through the use of capital placed at risk. Subjecting capital to risk requires an opportunity for a return for assuming the risk.

More specifically, in a free enterprise system, business attempts to increase the resources of the owners by employing (a) economic resources contributed by various persons, broadly defined into groups according to the risks assumed (creditors and owners) and (b) personal services and labor of its employees. The resources generated by business activity must first satisfy the obligations incurred for the use of resources contributed by creditors and the services of its employees. After paying obligations to governmental units imposed by the tax laws, the remaining increase in resources benefits the owners as earnings. Earnings represent the return to the owners for undertaking the risks of investment.

Various other goals are ascribed to business as a positive social force contributing in various ways to the happiness and welfare of our society, but the goal of earning a satisfactory return for the risks owners assume is a primary purpose through which other goals of business are met. The quality of a business and of its management is, therefore, judged primarily on the basis of success in achieving earnings.

Importance of Reliable Earnings Information. The earnings of a business are important not only to an owner who expects a return for the risk he is assuming in contributing his capital to the business but also (a) to the creditor in evaluating the risk he is assuming, (b) to the employee in establishing the basis to claim compensation for his services, and (c) to governmental units which base a major portion of their taxes on earnings.

As one might expect, therefore, information about earnings ordinarily constitutes the most important and useful financial information concerning a business entity. This information is significant to all who have rights and interests in a business and relates to the central purpose of business. The organization of a large portion of business activity today in the corporate form, with ownership interests (shares of stock) that are continuously traded, has created demands for reliable information about earnings on an annual basis and frequently for shorter periods as well.

Earning Power as Basis for Valuing the Shares of a Business. 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 governs, in the long run, the prices at which shares of stock in the business are traded. Future profits provide the basis for both dividends and investment growth, a point stated succinctly by W. B. Coutts:

> Reports of past activities can be useful as an indication of the success achieved in the past, as a basis for the evaluation of the relative strength of the enterprise, and as a means of judging the ability of the management to make the most of its opportunities. However, . . . it is the prospects for the future which really determine the value of the enterprise and provide the basis on which shareholders and investors make their decisions. One of the major needs of shareholders and investors is, as a result, for information on which to base such projections.[1]

The American Accounting Association recognized similar relationships:

> Almost all external users of financial information reported by a profit-oriented firm are involved in efforts to predict the earnings of the firm for some future period. Such predictions are most crucial in the case of present and prospective equity investors and their representatives--considered by many to be the most important of the user groups. Future earnings are the chief determinant of future dividends and future market prices of shares (given some predetermined price-earnings ratio), which, when taken together, are generally considered to provide the primary basis for establishing a subjective value for the shares. . . .[2]

How do accounting and financial statements serve the investors who appraise the earning power of a business? Financial statements provide a record of the past earnings of a business, a record which becomes an important basis for judging the future. The following statements by George O. May demonstrate a clear perception of the future-serving function of accounting.

> Financial accounting is now generally recognized as being primarily historical in character and as having for its most important function the extraction and presentation of the essence of the financial experience of businesses, so that decisions affecting the present and the future may be taken in the light of the past. . . .
>
> The sole relevance of accounts of the past is as throwing light on the prospects for the future.[3]

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[1] *Accounting Problems in the Oil and Gas Industry,* Canadian Institute of Chartered Accountants, 1963, p. 6.

[2] *A Statement of Basic Accounting Theory,* 1966, p. 23.

[3] *Financial Accounting,* 1943, p. vii (Foreword), and p. 8.

An important criterion, therefore, which should guide the presentation of information about the earnings of a business, is that the information be as useful as possible to investors in appraising the future prospects of the business—its earning power. This criterion, although often overlooked in everyday accounting practice, has long been recognized by accountants. As an example, the following objective was recommended to the New York Stock Exchange in 1932 by the American Institute of Accountants' Special Committee on Co-operation with Stock Exchanges:

> 3. To emphasize the cardinal importance of the income account, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity; and to take the position that an annual income account is unsatisfactory unless it is so framed as to constitute the best reflection, reasonably obtainable of the earning capacity of the business under the conditions existing during the year to which it relates.[4]

Investors Determine Value of a Business. The value of a business enterprise as determined in the marketplace—the aggregate market value of its outstanding stock—reflects primarily the attitude of stockholders and potential stockholders about the earning power of the enterprise and does not represent the sum of the current values which might be placed on individual separable resources and property rights which the business has devoted to achieving that earning power. That fact is the heart of the problem of accounting for goodwill.

The value of a business enterprise as a whole ordinarily does not constitute financial information which the investor should expect to find in the financial statements of the enterprise. J. M. Yang referred to the value of an enterprise as "commercial" value in his discussion of the problem of accounting for intangibles, stating:

> The solution of the problem lies in a careful differentiation between the commercial and accounting value of an enterprise, and this differentiation will in turn depend upon an analysis and understanding of the fundamental purposes of accounting. Misconceptions have frequently arisen on account of the failure to realize the limitations of accounting as an instrumentality for representing the true financial strength of an enterprise and as a result of the attempt to set up the accounting value of an enterprise on the basis of its earning capacity.[5]

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[4] *Audits of Corporate Accounts.* Correspondence between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932-1934, pp. 9-10.

[5] *Goodwill and Other Intangibles,* 1927, pp. 19-20.

"Commercial" value is the consequence of many factors other than data supplied by financial statements. In many instances these data are not susceptible of financial measurement and thus are not capable of inclusion in financial statements. Even so, financial information is necessary in determining "commercial" value, and one function of accounting is to supply that information. In fulfilling this function accountants must not confuse the facts which accounting is supposed to report with the values as to the business which result from the decisions of those using the financial information. The function of accounting is to furnish financial information to those appraising enterprise values; the values should not, in turn, affect or influence the tools used for the value decisions.

Value of Individual Resources Is Significant Financial Information. The total value of a business is not significant information to be supplied by accounting, nor does accounting purport to supply that information. However, an investor is interested in information about the value of the separable resources and property rights which the business has committed to achieving earnings. The value of the resources compared with the price the investor paid (or might pay) for his ownership is important information to him. The comparison provides a measure of the risk the investor assumes or the premium he pays in anticipation of future income. Also, the value of the economic resources is a general measure of the security which underlies the stockholder's investment. The stockholder's concern about the value of the resources of a business is demonstrated by the interests of the participants in a business combination.

Similarly, the creditor has an interest in the values of the individual resources of a business as well as their total value and the relation of resources to liabilities. Creditors are also interested in earnings, although their primary interest is in the resources produced by the earnings rather than the earnings themselves.

Raymond J. Chambers spelled out the significance of the values of the separable resources and property rights of a business and distinguished those values from the value of the business as a whole:

> Accountants in the ordinary course of accounting are not required to produce market assessments of the value of a going concern *in toto* or of particular shares in it. The market does this. But the right of investors and managers to have some comparable independent information on the values of assets and claims cannot be denied; comparison is essential to informed judgment, and comparison of security prices with balance sheet values is useless unless both are in current terms. . . . *Financial position* at any

> time can only have a useful meaning if it relates to the position a going concern occupies in the market situation then prevailing; and because of the severability of every asset, every claim and every specific relationship, the present value of every marketable thing or right is a necessary aspect of going concern value.[6]

Earnings are ordinarily the most significant financial information to those who use financial statements. However, the user of financial statements who looks for information on the resources of a business looks for information about their values.

The contentions of some accountants that "accounting does not try to reflect values" or that the balance sheet is "merely a repository for costs on their way to the income statement" suggest that the balance sheet has no significant purpose. The tendency of accountants to explain procedures or concepts from an "accounting standpoint," or to qualify explanations of financial terms with phrases such as "for accounting purposes," is unfortunate for it can be construed as an effort to substitute restrictive terms for properly assuming responsibilities to meet the objectives of accounting. Raymond J. Chambers aptly stated:

> If accounting statements are to convey information, accountants must first see things as the users would see them if they were able; there is no room for a special accounting viewpoint interposed between the facts and those who must act upon them.[7]

Accounting Conventions and Concepts

As discussed in the preceding paragraphs, the most important financial information provided by accounting is information about earnings, since earnings relate to the central purpose of business activity. The appraisal by investors of the earning power of a business is the principal factor which establishes the total value of a business—the total market value of its outstanding stock.

Thus, financial information about a business provided by accounting is used by investors to make decisions which, in the aggregate, establish the value of the business. The purpose of accounting is not to determine the value of the business as a whole or to provide information as to that value. The distinction is clear: accounting provides

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[6] "The Resolution of Some Paradoxes in Accounting," *Occasional Paper No.* 2, Faculty of Commerce and Business Administration, University of British Columbia, 1963, p. 13.

[7] *Ibid.*, p. 7.

information used by investors in reaching decisions which lead to a measure of the value of the business as a whole, but accounting does not provide, nor is its purpose to provide, information as to the value of the business as a whole. An objective of accounting, as discussed previously, is to provide some information concerning the value of the separable resources and property rights used by a business in the production of earnings, which information is of significance to the users of financial statements.

Irrespective of attempts to define terms such as "earnings" and "values of resources," they mean different things to different people, a fact vividly described as follows: ". . . the question, What is the business income for a year . . . is one that may . . . bear a fairly close analogy to the question, What is the color of a chameleon? For income, like color, is dependent on external conditions, and a matter of imperceptible gradations from one extreme to another. And the corporation has in relation to income an even greater capacity for adaptation than the chameleon has in relation to color."[8]

The traits or attributes of earnings and values created a need for some accounting conventions and concepts governing the manner in which the earnings and values of the resources of a business are reported in its financial statements. The conventions and concepts provide the practical framework by which accountants seek to meet financial statement objectives with data which have been measured or determined with reasonable standards of objectivity and consistency.

Realization Principle and Measurement of Earnings. How does accounting measure the earnings of a business as reported for specific periods in a statement of income?

Accountants today generally consider it impracticable to measure the earnings of a business enterprise by annual revaluations of all of an enterprise's resources. Instead, accountants have adopted the "realization principle" for recognizing revenue. Under this principle, revenue is ordinarily recognized after the production or service process is complete and a sale is made. The principle is applied with useful exceptions, such as the percentage-of-completion method of recognizing revenue on long-term construction contracts and the recognition of changes in market values of securities owned by investment companies.

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[8] Report of Study Group on Business Income, *Changing Concepts of Business Income*, 1952, pp. 18-19.

The recognition of revenue near the conclusion of the earnings process and the periodic reporting of earnings emphasize the need for appropriate allocation of costs to the related revenue, which underlies many of the current accounting problems. The conventions adopted to match costs and revenue are outlined in subsequent paragraphs of this chapter and are significant to certain aspects of the problem of accounting for goodwill.

The recognition of revenue after the earnings process has been substantially completed can be challenged as not representing the real facts about earnings—the determination of which is the most important single objective of accounting. The realization principle generally recognizes revenue at the moment of sale, although profits result from the entire process of production and sale. *ARS 3* states, as a principal conclusion:

> Profit is attributable to the whole process of business activity. Any rule or procedure, therefore, which assigns profit to a portion of the whole process should be continuously re-examined to determine the extent to which it introduces bias into the reporting of the amount of profit assigned to specific periods of time.[9]

George O. May also acknowledged the theoretical deficiencies of the realization principle.

> Manifestly, when a laborious process of manufacture and sale culminates in the delivery of the product at a profit, that profit is not attributable, except conventionally, to the moment when the sale or delivery occurred. The accounting convention which makes such an attribution is justified only by its demonstrated practical utility.[10]

The realization principle can and does produce significant distortions of earnings in some industries and for certain kinds of business transactions when considered in terms of reasonable concepts of income or value. The distortion may be particularly significant when the principal activities of a business enterprise are the exploration for and discovery of natural resources or the long-term development of resources, such as timber. The realization principle does not recognize the resources acquired as a result of successful exploration, discovery, or long-term development until some future date when those resources are sold. Earnings may thereby be reported in periods in which the

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[9] Robert T. Sprouse and Maurice Moonitz, *Accounting Research Study No. 3*, "A Tentative Set of Broad Accounting Principles for Business Enterprises," 1962, p. 55.

[10] *Financial Accounting*, 1943, p. 30.

resources of a business are decreasing rather than increasing as a result of its current operations.

Generally, the objective that information provided by financial statements be useful demands considerable certainty in the amounts which are included in the financial statements. As one study noted, "Economists might disagree with the accounting view; accountants might agree with the economists that a gradual recognition of revenues on the basis of accretion might be theoretically preferable, but they might reject it as too seldom capable of implementation."[11]

The accrual of profit over the period of purchase, production, and other business activity, in the typical merchandising or manufacturing concern, would not likely result in earnings reports which would be more useful than those resulting from the recognition of revenue under the realization principle, particularly when weighed against the loss of certainty. As George O. May noted,

> It is instructive to consider how it happens that a rule which is violative of fact produces results that are practically useful and reliable. The explanation is, that in the normal business there are at any one moment transactions at every stage of the production of profit, from beginning to end. If the distribution were exactly uniform, an allocation of income according to the proportion of completion of each unit would produce the same result as the attribution of the entire profit to a single stage.[12]

Improvement is needed in the reporting of earnings to eliminate any significant distortions which result from applying the realization principle in recognizing revenue. In spite of its shortcomings, the realization principle has produced results which are usually desirable and useful. The distortion from a more theoretically sound approach is ordinarily insignificant because the earnings process in most businesses covers a relatively short period.

Cost Basis in the Balance Sheet. Deferring revenue recognition until the earnings process is complete and a sale is made necessitates similarly deferring recognition of increases in values of the resources reported in the balance sheet. Thus, the use of the realization principle to recognize revenue has as its corollary the cost basis of carrying assets: inventories and other "unrealized" assets are stated at cost, but cash and claims arising from sales (receivables) are stated at current values since they are "realized."

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[11] Report of Study Group on Business Income, *Changing Concepts of Business Income,* 1952, p. 104.

[12] *Op. cit.,* p. 30.

Although the cost basis does not satisfy completely the general need of the investor and creditor for information regarding the values of the separable resources and property rights employed by a business, the cost basis does convey considerable information as to values. The greatest deficiency of the cost basis in conveying useful information lies in the same areas in which the realization principle results in a distortion of reported earnings, such as the failure under the realization principle to recognize the values of resources acquired through exploration, discovery, or long-term development. Also, the importance of a relatively high certainty and objectivity in the amounts reported in financial statements adds to the usefulness of the cost basis, although usefulness does not necessarily vary directly in proportion to the certainty.

Assets and Matching. Matching costs with the related revenue is a balance-sheet problem as well as an income-statement problem. What costs should be carried forward and recognized as expenses of future periods? What costs should be recognized as expenses when incurred?

The question of which amounts should be deferred to the future and which should be recognized as expenses when incurred is undoubtedly a primary question in accounting and is involved in substantially every accounting problem which the profession now faces. Most of the important alternative practices in accounting today relate to alternatives in the matching of costs and revenue. A description in 1932 of the difficulties relating to this question is equally applicable today.

> Some method, however, has to be found by which the proportion of a given expenditure to be charged against the operations in a year, and the proportion to be carried forward, may be determined; otherwise, it would be wholly impossible to present an annual income account. Out of this necessity has grown up a body of conventions, based partly on theoretical and partly on practical considerations, which form the basis for the determination of income and the preparation of balance-sheets today. And while there is a fairly general agreement on certain broad principles to be followed in the formulation of conventional methods of accounting, there remains room for differences in the application of those principles which affect the results reached in a very important degree.[13]

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[13] *Audits of Corporate Accounts.* Correspondence between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932-1934, p. 6.

In deciding which costs are to be deferred (carried as assets with future productive value) and matched with revenue of the future and which are to be considered expenses as incurred and charged against current revenue, accountants have generally been guided by practical considerations, although most practices also have been sound in theory. Some conventions, broad rules, and traditional practices have evolved to govern the decisions whether to defer an expenditure as an asset to be recognized as an expense related to future revenue or to recognize it as an expense in the period incurred. The adopted practices have to some extent been used as criteria in finding solutions to related accounting problems. However, present customs or practices are themselves subject to modification and improvement.

The following approaches have governed accounting practices to a large degree:

1. Costs are deferred and recognized as assets only when future income benefits are reasonably certain and the period of benefit is reasonably clear. Estimates are required for matters relating to the future, and lack of absolute certainty does not obviate using estimates to achieve reasonable measures of underlying conditions.

2. Costs deferred on the basis of their future income benefit are costs incurred for (a) purchases and production applicable to inventories of goods and services to be delivered in the future, (b) purchases and construction of plant, equipment, and facilities, and (c) other identifiable items related to specific property rights or contracts, such as patents, development costs of mines, prepaid insurance premiums, commissions or direct selling expense applicable to sales orders yet to be fulfilled, and some research and development costs.

3. Costs deferred as assets are for the most part attributable to specific resources which have values in and of themselves, apart from the business as a whole. The one principal exception is in the accounting for purchased goodwill. However, expenditures for the benefit of the organization as a whole—goodwill created internally—generally have not been reported as assets (see Chapter 6).

4. Generally no attempt is made to report as assets everything which has a value to the future of a company or all

> costs which may have future income benefits. A wide range of items may exist, including the intellectual ability and the physical health of the management, the effectiveness of the organization, the quality of the sales force, and the competitive advantage created by a well-known name resulting from general public relations efforts. All are attributes which may have required expenditures and may be more important factors in the success of a business than any individual tangible resource. Accounting cannot and does not measure those attributes. Accounting does supply information, principally about earnings, which attests to the existence and quality of the attributes—information which the investor may use to establish a value of the entire business.

Raymond J. Chambers made a pertinent observation related to item 4.

> It is pointless to consider the skill, acumen and foresight of management and the organized arrangement of its facilities as assets; they will both be reflected in earnings and hence in market evaluations of securities. It is unnecessary and incompetent for accounting to recognize them, for the skill of management may be lost or withdrawn and any given arrangement of facilities may be altered.[14]

Criteria and Guides for This Study

The following conclusions, based on the discussion in this chapter of financial statement objectives and accounting conventions and concepts, are used as criteria or guides in this study to determine the appropriate accounting for goodwill:

1. *Usefulness*—The final test of the soundness of a particular accounting practice lies in the usefulness of the information provided by financial statements as a result of that practice. Financial information is of no significance unless it can be used. This concept may seem too obvious to be designated as a criterion or guide; nevertheless it is frequently overlooked. Too often the effort is to apply

[14] "The Resolution of Some Paradoxes in Accounting," *Occasional Paper No. 2,* Faculty of Commerce and Business Administration, University of British Columbia, 1963, p. 13.

logic and consistency without considering the uses of financial information.

2. *Comparability*—The decisions of investors and creditors involve choosing the investment and lending opportunities in one business over those in other businesses. The information provided by financial statements can be useful for those purposes only if it is comparable among businesses and the differences between the earnings and financial position of the individual businesses are disclosed. Differences in reporting should reflect differences in facts and circumstances and not differences resulting from alternative accounting practices.

3. *Financial Statements Serve the Future*—The value of a business as established by the investors reflects the investors' appraisal of the earning power of the business. Accounting serves the investor by providing information on past earnings which is useful when it helps the investor appraise future earnings. Thus, statements of income should be prepared to make them most useful in appraising the future profits of the business—its earning power.

4. *Current Values of Resources (Assets)—Important Information*—Since investor decisions on enterprise value look primarily to the future, financial data expressed in current terms are generally of prime usefulness. To the extent that the balance sheet reports noncurrent values, the information falls short of maximum usefulness for stockholders and creditors.

5. *Enterprise Value Determined by Investor—Not an Accounting Function*—Investors appraise the prospects of a business and establish its value. Investor opinion, good or bad, may be influenced by innumerable factors. Accounting serves the investor by providing financial information about a business to help him establish the value of that business. Investor decisions about values of businesses should not influence the information which accounting provides for the investor to establish those values.

6. *Broad Accounting Conventions and Concepts*—Accounting, for the most part, employs the realization principle to recognize revenue. This principle has as its corollary

the cost basis of carrying assets in the balance sheet. Under the realization principle, revenue is ordinarily recognized when the earnings process has been substantially completed. Acceptance of accounting conventions for recognizing revenue and for reporting asset values gives rise to the central problem in accounting—the matching of costs with related revenue to properly measure and report earnings by periods.

All costs must be assumed to be incurred to contribute to earnings, but all costs are not deferred. Generally, deferring costs as assets has been limited to those items which (a) have reasonably clear periods of revenue benefit; and (b) are directly associated with or attached to specific separable resources and property rights which have values in themselves apart from the business as a whole. (An exception has been the treatment of purchased goodwill, discussed in Chapter 4.)

Some expenditures relating to the future have been deducted in the current income statement, since they do not meet the broad criteria for deferment mentioned in the preceding paragraph. For example, expenditures (sometimes substantial) which are ordinarily not deferred are those to develop a product and gain public acceptance of it, to improve the effectiveness of management, to enhance the quality of customer relationships, and to create favorable attitudes to the business in the financial community. Thus, a balance sheet does not necessarily include all costs incurred to earn future income.

Decisions on individual accounting problems should generally be broadly consistent with the general conventions adopted by accountants for matching costs and revenue and for deferring costs. However, the decisions must always be made with a view to improving the usefulness of the financial statements.

4

Evolution of Accounting for Goodwill and Business Combinations

Purchase Accounting

Conflicting Views. Before the 1950's, most business combinations in the United States involving independent parties were viewed and accounted for as purchase transactions. Nevertheless, considerable differences in accounting practices existed in those years, including a variety of treatments of purchased goodwill.

Under purchase accounting, the assets acquired in a business combination are recorded "on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more clearly evident."[1] Fair values as of the date of the combination are assigned to the individual assets acquired and to the liabilities assumed; the difference between (a) the total consideration given and (b) the fair value of tangible assets and intangibles representing property rights, such as patents, less liabilities is designated as an intangible. Ordinarily, the designated intangible is referred to as purchased goodwill.

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[1] *Accounting Research Bulletin No. 48*, "Business Combinations," 1957, par. 8.

Accounting for purchased goodwill has been the most difficult problem under purchase accounting for business combinations and has been the subject of considerable controversy among accountants for at least three quarters of a century. The growth and diversification of business activity, the expansion of public ownership of business, the widespread trading of ownership interests in today's business enterprises, and the frequency with which business combinations occur have increased the complexity of the problem and emphasized the importance of proper accounting for business combinations.

The problem of goodwill became increasingly significant with the emergence of the limited liability, or corporate, form of doing business in the latter half of the nineteenth century. Prior to that time, accountants appeared in substantial agreement that amounts expended for goodwill should not be carried very long in the balance sheet.[2] The introduction of capital as a legal concept designed to protect creditors under the corporate form of business enterprise raised questions as to the propriety of charging purchased goodwill to capital. Concern about the charge-off of goodwill to capital is illustrated by the views expressed by E. A. Browne in 1902.

> First: *Of a Private Concern.*—In my opinion Goodwill in this case should not appear as an asset in a private Balance Sheet, but it should be at once eliminated by a debit to capital. I certainly hold that it is an error of principle to write it off through Profit and Loss Account....
>
> Secondly: *Its Treatment in the Books of a Limited Company.*—Here we arrive at a point where opinions differ widely. Obviously the elimination of Goodwill is not possible through the Capital Account of a company, as the subscribed capital cannot be increased or decreased, except by methods laid down in the Companies Acts. We can therefore only deal with it out of profits. My opinion ... is that as Goodwill is an asset distinctly paid for by shareholders and represented in their capital on the opposite side of the Balance Sheet, profits should not be subject to a charge for its reduction or extinction.
>
> I do not go so far as to say that it may not be desirable in many cases to strengthen a concern by reducing, under special circumstances, the book value of its Goodwill, but the application of profits in this direction would be more in the nature of a voluntary appropriation than a necessary charge.[3]

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[2] William Harris, "Goodwill," *The Accountant,* April 5, 1884, p. 11.

[3] "Goodwill: Its Ascertainment and Treatment in Accounts," *The Accountant,* December 20, 1902, p. 1342.

Some accountants, however, advocated the write-off or elimination of goodwill from the balance sheet. Some favored amortization of goodwill, but others believed that goodwill represented a cost which should not be amortized.

P. D. Leake stated, "I think . . . that wherever capital has been laid out in the purchase of rights to carry on industrial and commercial enterprises, and remains as an asset in the books of an undertaking, some provision should be made and charged to Revenue Account in every year in which super-profits have been earned."[4]

In response to Leake's remarks, W. R. Hamilton submitted several comments which included the following:

> As to the propriety of a company's writing off its goodwill, I do not see the theoretical necessity. I suppose Mr. Leake's argument is that, as the super-profit anticipated at the moment of purchase cannot be permanent (which is very true), each year sees a lessening of its value, and that the accounts should take note of this. But a company is (in theory) undying, and each year which sees a portion of the original goodwill run off sees an accretion to the goodwill of an equal amount; an accretion due to the company itself, and therefore a legitimate asset.[5]

In an address before the Birmingham Chartered Accountant Students' Society, Lawrence R. Dicksee saw the problem of accounting for goodwill as a dilemma for a limited company:

> . . . there is a very powerful argument [with regard to "sole trader or private firm"] in favour of the amount standing to the debit of Goodwill being written off with all due speed. Unquestionably, however, the amount should not be written off out of profits; it has no connection whatever with profits in the sense that it is of a wasting nature, but none the less is it an asset which it is undesirable to retain as such, and the proper method of dealing with it clearly seems to be to at the earliest possible stage debit Capital Account and credit Goodwill Account with the whole amount of the Goodwill. . . .
>
> Coming now to the consideration of Goodwill in relation to the accounts of a company, there are two points to be considered. In the first place all that I have said as to the undesirability of the cost price being retained as a permanent asset applies here; but, on the other hand, when the value of the Goodwill has been paid for out of *capital* it is practically impossible for it to be written

[4] "Goodwill: Its Nature and How to Value It," *The Accountant*, January 17, 1914, p. 87.

[5] "Goodwill," *The Accountant*, February 14, 1914, pp. 217-218.

off, except out of profits which (as I have already shown in the case of a private firm) is quite incorrect.[6]

Dicksee suggested a possible solution for a newly formed company which uses shares of stock to acquire assets, including goodwill. He asked:

> How would it be to let the share capital be fixed upon such a basis as to supply the necessary funds to acquire the tangible assets purchased, . . . and in order to provide the necessary funds to acquire the Goodwill of the undertaking, let the shares be issued at such a premium as would amount to the price to be paid to the vendor for Goodwill?[7]

Dicksee recommended that financial statements disclose parenthetically the portion of the premium on capital stock which applied to the purchase of goodwill.[8]

J. M. Yang also saw the problem as a dilemma since he believed no reliable way could be found to relate earnings to intangibles. He then suggested as an expediency that intangibles be amortized over the earnings-capitalization period used in calculating the purchase price:

> In solving the problem whether intangible assets should be depreciated, reliance should not be placed solely upon the state of earnings realized periodically, for earnings . . . do not furnish us with the true criterion for determining the life of the properties involved. Furthermore, supposing it were definitely ascertainable that earnings from intangible factors were sufficient to maintain their original value, one would yet be confronted with the task of determining whether the earnings were applicable to the intangible factors bought from the predecessor, or whether the same earnings might have been brought about by factors created by the purchaser himself.
>
> In view of this, it may be perfectly possible that . . . the value of intangibles actually purchased has vanished altogether, and that new intangible values have been accrued to the extent of the payment in the original purchase. . . . Dividends might have been declared out of capital for the reason that revenues [profits] had been overstated due to a failure to recognize the depreciation of intangibles. The asset would be validated on the basis of the capitalized

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[6] "Goodwill and its Treatment in Accounts," *The Accountant,* January 9, 1897, pp. 46-47.

[7] *Ibid.,* p. 47.

[8] Lawrence R. Dicksee and Frank Tillyard, *Goodwill and its Treatment in Accounts,* Fourth Edition, 1920, p. 135.

> value of the efficiency of the proprietor. In the face of this apparent dilemma we have to find a rational or perhaps expedient rule to adopt in handling the intangible assets. The logical principle seems to be that the assets should be written off during the periods for which the excess earnings were capitalized when calculating the purchase price.[9]

Henry Rand Hatfield stated at about the same time that the amortization of goodwill is justified on the plea of conservatism, but when its value is impaired, the best method of adjustment is to offset the decline in its value by a reduction of capital, not by amortization to income.[10]

A somewhat different view was expressed later by W. A. Paton and A. C. Littleton. They viewed a position that goodwill is not subject to amortization as unsound, stating:

> The cost of goodwill included in the purchase price of a going concern is essentially the discounted value of the estimated excess earning power—the amount of the net income anticipated in excess of income sufficient to clothe the tangible resources involved with a normal rate of return. Thus purchased goodwill represents an advance recognition of a debit for a portion of income that is expected to materialize later. It follows that the amount expended for goodwill should be absorbed by revenue charges—during the period implicit in the computation on which the price paid was based—in order that the income not paid for in advance may be measured. . . .
>
> Even if a superior level of income persists beyond the period anticipated, the amortization of the cost of goodwill in terms of the original computation is generally justified on the ground that there is no way of demonstrating that the later earning power is due to factors and conditions present when the business was acquired.[11]

Roy B. Kester expressed a preference for writing down goodwill to a nominal sum, realizing that to do so might create a secret reserve justified on the ground of prudence. He stated that if goodwill really exists, the profit and loss record is the best evidence of it. That, he said, should be the guide as to its measurement, not the amount carried in the balance sheet.[12]

Those are but a few of the conflicting views which have been expressed by accountants during the last 80 years. The controversy over proper accounting for goodwill continues in a remarkably similar

[9] *Goodwill and Other Intangibles*, 1927, pp. 195-196.
[10] *Accounting*, 1927, pp. 124-125.
[11] *An Introduction to Corporate Accounting Standards*, 1940, pp. 92-93.
[12] *Advanced Accounting*, 1946, pp. 368-369.

vein today, with many of the same arguments advanced by proponents of the various practices.

Accounting Research Bulletins of the AICPA. Various practices in accounting for purchased goodwill have been sanctioned in the past in the United States. The practices have included: (a) immediate write-off of the cost of purchased goodwill to any available surplus (capital or earned); (b) amortization of the cost by charges to income; and (c) retention of the cost until the goodwill becomes worthless or until it becomes reasonably evident that the term of its existence is limited. *Accounting Research Bulletin No. 24* issued in 1944 recognized all of these practices as acceptable.

ARB 24 permitted the cost of goodwill deemed to be worthless to be "charged off either in the income statement or to earned surplus as, in the circumstances, may be appropriate." In determining whether an investment in purchased goodwill had become or was likely to become worthless, *ARB 24* stated, "it is proper to take into account any new and related elements of intangible value [goodwill], acquired or developed, which have replaced or become merged with such intangibles [goodwill]." As to the direct write-off of goodwill to any existing surplus (capital or earned), even though its value was unimpaired, the bulletin stated:

> Since the practice has been long established and widely approved, the committee does not feel warranted in recommending, at this time, adoption of a rule prohibiting such disposition. The committee believes, however, that such dispositions should be discouraged, especially if proposed to be effected by charges to capital surplus.

The AICPA's current position on accounting for goodwill under purchase accounting is set forth in the discussion of intangibles in Chapter 5 of *ARB 43* issued in 1953. *ARB 43* presents one significant change from the prior bulletin on intangibles, in that it does not recognize as an acceptable practice the lump sum write-off of goodwill to retained earnings immediately after acquisition or the charge-off of intangibles to capital surplus. Paragraph 9 of the bulletin states: "Lump sum write-offs of intangibles should not be made to earned surplus immediately after acquisition, nor should intangibles be charged against capital surplus."

Chapter 5 of *ARB 43,* as amended by *APB Opinion 9*, continues much of the latitude in accounting for goodwill contained in *ARB 24*. *ARB 43* states in substance that as long as limited existence or loss of value of goodwill is not indicated, the cost need not be amortized or written off. However, the cost may be amortized under some reasonable and systematic plan, even though limited existence or loss of value is not evident, but this is discretionary and not obligatory. *ARB 43* provides further that when it becomes reasonably evident that the life of such an intangible has become limited, its cost should be amortized to income over the estimated remaining useful life. However, under *APB Opinion 9*, if the evidence of limitation of life is due to unusual events or developments during the period and the amount of loss of value is material, the amount of such loss should be reported as an extraordinary charge to income.

ARB 43 provided, as did *ARB 24*, that if reasonable evidence exists that goodwill has become worthless, the cost should be charged to income; or, if the amount is so large that the effect on income might give rise to misleading inferences as to earnings, the cost should be charged to retained earnings. *APB Opinion 9* modified *ARB 43* in that a charge to retained earnings is no longer acceptable; any large write-off of goodwill should be reported as an extraordinary charge to income. To determine whether goodwill has become worthless, *ARB 43* states that "consideration should be given to the fact that in some cases intangibles acquired by purchase may merge with, or be replaced by, intangibles acquired or developed with respect to other products or lines of business and that in such circumstances the discontinuance of a product or line of business may not in fact indicate loss of value."

ARB 43 does not examine or discuss the nature of goodwill as a basis for (a) carrying its cost as an asset or (b) amortizing the cost to income. The discussions in the bulletin relate to purchased intangibles such as purchased goodwill, and the bulletin specifically states that it does not "deal with the problems of accounting for intangibles developed in the regular course of business by research, experimentation, advertising, or otherwise." Thus, *ARB 43* does not attempt to reconcile the recommendations in the bulletin for accounting for the cost of purchased intangibles with practices followed in accounting for the value of intangibles developed internally by a business.

ARS 5 contains a summary of the varied accounting treatment of the difference between "cost" and "book value" in 175 business combinations during the twelve years 1949 to 1960. In approximately 36% of the combinations during 1949 to 1952 in which cost was in excess of the acquired company's book value, the difference became an immediate charge directly to retained earnings.[13] After issuance of *ARB 43* in 1953, the number of charges to retained earnings for the cost of purchased goodwill decreased rapidly, and the treatment is not considered acceptable today.

ARS 5 also reported a trend to amortize the amounts recorded as goodwill. During 1949 to 1952, 25% of those companies which recorded purchased goodwill subsequently amortized the amount. The practice of amortization was followed in 50% of the cases reviewed from the 1954-to-1956 period and in over 75% of such cases during 1958 to 1960. At the same time, an increasing number of business combinations were being accounted for as poolings of interests which, as described later, gives no accounting recognition to goodwill.

The 1967 edition of *Accounting Trends & Techniques* contains a summary of the accounting treatment of intangibles by the companies included in the survey. The 1966 balance sheets of 344 of the 600 companies reviewed included 640 variously described intangible assets of which 192 were described as "goodwill." A summary of the accounting treatment of goodwill by the 192 companies is:

	Number of Reports	*Percent of Total*
Written down to a nominal value	35	18%
In process of amortization	43	22
Nonamortization	72	38
Accounting treatment not determinable	42	22
	192	100%

Pooling of Interests Accounting

Many early business combinations changed the form of business entity only; for example, the merger of two subsidiaries of the same parent company. The book values and retained earnings of the merged subsidiaries were carried forward logically into the accounts of the resultant entity. The practice of carrying forward the book values and retained earnings of the constituents—characteristics of a pooling of interests—was later extended to certain combinations involving ex-

[13] Arthur R. Wyatt, *Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations," 1963, pp. 30-33.

changes of equity securities between independent parties. Thus, while pooling of interests was not recognized prominently as a method of accounting for business combinations until the late 1940's, important characteristics of the pooling method emerged earlier in practice.

Today, pooling of interests and purchase accounting are generally regarded as acceptable alternatives for substantially all business combinations effected by an exchange of voting stock.

The underlying concept for the pooling of interests method of accounting for business combinations is that an exchange of voting stock between a business entity and the stockholders of another entity results in the merger ("marriage") of one entity with the other and no new basis of accountability for the continuing enterprise is necessary.

Under a pooling of interests, the book values of both businesses are retained in the accounts of the continuing company, without adjustment to fair values at the date of the transaction. Pooling of interests accounting has generally been limited to combinations in which voting stock, as opposed to cash, notes, or other property, has been issued as consideration in the transaction. As described later, pooling of interests practices have been applied when all cash was used, by purchasing and reissuing treasury stock and by other indirect procedures.

The first official recognition by the AICPA of pooling of interests as an accounting concept for business combinations was *ARB 40* issued by the committee on accounting procedure in 1950. The committee issued two additional statements on accounting for business combinations and poolings of interests—Chapter 7C of *ARB 43* in 1953 and *ARB 48* in 1957.

ARB 40 — Two Types of Business Combinations. *ARB 40* sought to distinguish between two types of business combinations: (1) those in which the former ownership interests continued—a pooling of interests and (2) those resulting in new ownership interests—a purchase. The bulletin discussed a variety of criteria which were to be used as the basis for deciding which type of business combination was involved in a given transaction. The "attendant circumstances" were emphasized as being more important than the legal designation of the transaction, the tax treatment, or the availability of net assets for dividends.

The criteria listed in *ARB 40* for distinguishing a pooling of interests from a purchase, no one of which criteria would "necessarily be determinative," but whose "presence or absence would be cumulative in effect," were:

1. Ownership interests in predecessor corporations continue in substantially same proportions in surviving or new company.
2. Relative size of constituent companies not too disproportionate.
3. Management of all constituents continue as influential in management of surviving or new company.
4. Business activities of constituents similar or complementary.

The accounting treatment recommended by *ARB 40* did not require that the retained earnings of all constituent companies be carried forward in a pooling of interests and did not refer to the manner of presenting prior year income statements of the continuing company. The accounting treatment recommended in the bulletin for pooling of interests, however, was essentially the same as that recommended in

later bulletins and that which exists in practice today—carrying forward in the accounts of the continuing company the book values (after any adjustments to a uniform basis "when deemed necessary") of the assets and liabilities of the constituent companies.

ARB 43, Chapter 7C—An Attempt to Clarify. Chapter 7C of *ARB 43* issued in 1953 was almost identical to the previous bulletin, except that it considered briefly the question of presenting the prior year statements of income of the constituents in a pooling of interests. Although the bulletin continued to permit, but not require, the carrying forward of the retained earnings of the constituents, it stated that when retained earnings were combined and carried forward the "statements of operations issued by the continuing business for the period in which the combination occurs and for any preceding period should show the results of operations of the combined interests."

ARB 48. *ARB 48* issued in 1957 was the last pronouncement by the committee on accounting procedure on the subject of business combinations. That bulletin continued to distinguish two types of business combinations, poolings of interests and purchases, and set forth essentially the same criteria as the prior bulletins for distinguishing the two types.

The descriptions of the pooling of interests criteria were modified slightly from those contained in earlier bulletins in that (a) "similar or complementary" business activities were not mentioned as a factor, (b) abandonment or sale of a large part of the business of one or more of the constituents was introduced as evidence of a lack of continuity which "militates" against considering a transaction a pooling of interests, and (c) the importance of limits on the relative-size criterion was indicated by citing (as an example) that when stockholders of one constituent company obtain 90% to 95% or more of the voting interest in the combined company, the presumption is that the transaction is a purchase.

The more significant new comments or recommendations in *ARB 48* were:

1. The retained earnings of the constituent companies in a pooling of interests should be combined, except to the extent otherwise required by law or appropriate corporate action.

2. The presentation of operating statements of the constituent companies for current and prior periods was covered more extensively. The statements of the results of operations of the constituents for the period in which the combination occurs and for any prior periods presented for comparative purposes should ordinarily be combined; if the statements are not combined, separate statements of the constituents should be presented for those periods. *Statements On Auditing Procedure No. 31* issued by the American Institute's committee on auditing procedure in 1961 (later codified as Chapter 8 of *Statements On Auditing Procedure No. 33* issued in 1963) provided that auditors should treat failures to follow those recommendations for presentation of results of operations for prior years as an absence of consistency in the application of generally accepted accounting principles.
3. The continuance as a subsidiary of one of the constituent companies in a business combination did not preclude a

pooling of interests so long as no significant minority interest in the subsidiary remained outstanding.

4. Business combinations treated as poolings of interests should be disclosed in the financial statements "and any combined statements clearly described as such."

APB Opinion 10—Amended ARB 48. *Opinion 10* of the Accounting Principles Board, issued in December 1966, amended the portion of *ARB 48* concerning the combining of financial statements of the constituents in a pooling of interests. A principal change eliminated the option provided in *ARB 48* of presenting the separate statements of the constituents in lieu of combining them. Another change dealt with poolings of interests consummated at or shortly after the close of the fiscal period and concluded that:

> . . . if the pooling is consummated at or shortly after the close of the period, and before financial statements of the continuing business are issued, the financial statements should, if practicable, give effect to the pooling for the entire period being reported; in this case, information should also be furnished as to revenues and earnings of the constituent businesses for all periods presented.

The latter change recognized officially the practice which had developed of giving effect in financial statements to poolings of interests consummated between the date of the financial statements and the date the statements were issued. This practice is an extension of the pooling of interests concept to reflect the view that after a pooling the constituents appear as if they had always been a single business enterprise.

Accounting Methods Clarified. The methods used in the years that pooling of interests accounting was emerging were somewhat confusing. For example, in a majority of the combinations during 1949 to 1952 which were reviewed in connection with *ARS* 5, the retained earnings of the absorbed companies were not carried forward.[14] Neither *ARB 40* nor Chapter 7C of *ARB 43* required that the retained earnings of the constituents of a pooling be carried forward, but described this practice as permissive. Carrying forward the

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[14] Arthur R. Wyatt, *Accounting Research Study No.* 5, "A Critical Study of Accounting for Business Combinations," 1963, p. 32.

retained earnings of the absorbed companies became the common practice after 1952.

In accounting literature and in the practices currently followed, the distinctions in accounting entries between purchases and poolings of interests are now clearly defined. However, the distinctions between business combinations that are to be treated as purchases and those that are to be treated as poolings are more confused than ever. The criteria set forth in *ARB 48*, which were designed to furnish guides as to whether business combinations were to be treated as poolings of interests or as purchases, have come to be regarded as inappropriate or inadequate bases for distinction.

Increase in Popularity of Pooling of Interests. Pooling of interests, generally regarded as a permissive and not mandatory method of accounting for a specific combination and originally conceived as having rather limited application, rapidly developed into a popular alternative to purchase accounting. Thus, one additional practice was added to those already in existence for the handling of goodwill under purchase accounting—that is, nonrecognition in the accounting records of the continuing enterprise of the goodwill of the absorbed companies. In addition, pooling of interests also (a) introduced other alternative practices through the nonrecognition of the excess over book values of the fair values of the separable resources and property rights of the absorbed companies, and (b) created another alternative by providing for the combination of the historical income and retained earnings statements of the constituent companies.

A number of conditions in the 1950's exerted pressures to broaden the application of the pooling of interests method of accounting for business combinations. First, the position on accounting for intangibles in Chapter 5 of *ARB 43* issued in 1953, which prohibited immediate charge-off of goodwill to surplus (capital or earned) at the time of the transaction, undoubtedly expanded significantly pooling of interests accounting.

The opportunities for tax-free exchanges of securities stimulated issuing stock rather than distributing cash in business combinations. At the same time, inflation and the general rise in stock market prices increased the differences between the book values of underlying assets of businesses and the market values of their outstanding common stocks. These conditions led to an increasing reluctance to account for a business combination as a purchase if other acceptable alternatives were available.

Purchase accounting in the circumstances described would have resulted in recording enormous amounts of additional costs, including goodwill, in the financial statements. The consequences of purchase accounting, including charges to earnings for depreciation and depletion applicable to the additional amounts recorded and, in some cases, for amortization of purchased goodwill, provided an incentive to corporate managements to establish business combinations on bases acceptable for pooling of interests accounting. Over a relatively short period most of the criteria for pooling of interests enumerated in *ARB 48* were, for all practical purposes, abandoned as inadequate, impracticable, or not meaningful.

Almost any business combination in which voting stock is issued as a major portion of the consideration, as opposed to cash, bonds, or other property, can now be accounted for either as a pooling of interests or as a purchase. When cash is a substantial portion of the total consideration and the remainder is stock, the transaction is sometimes treated as a partial pooling and a partial purchase. When cash, bonds,
50 or other property is the total consideration in a combination, purchase accounting is generally required. However, cash may be the consideration and purchase accounting may be avoided, if a company first buys its own stock for cash and then issues the treasury stock to effect a pooling of interests.

Other variations (of which there are many) have included the "downstream merger" technique. In a downstream merger, one company purchases for cash all or part of the shares of another company, and subsequently a merger is effected so that the continuing entity (the acquiring company in business substance, but not in a legal sense) is merged into the acquired company. In effect, when the merger is consummated the stock acquired becomes treasury stock of the legally surviving company and the cost of the stock, including the excess of the cash consideration paid by the purchasing company over the book value of the acquired company's net assets (which excess would ordinarily be allocated to resources, property rights, and goodwill by the purchasing company) is deducted from the stock and surplus in accounting for the merger. In substance, the accounting result is the same as if the transaction had been consummated by an exchange of stock in a pooling of interests, even though the combination was actually effected wholly or in part by cash.

Another problem area in pooling of interests relates to the continuance of the absorbed business as a subsidiary of the continuing entity, with questions as to the effect of remaining minority interests in the absorbed business and as to the appropriate accounting by the parent company. Another question relates to the legality of the pooling of interests method under certain state laws in the absence of a statutory merger. (See also pages 65 to 66.)

One other problem is the merger which is accounted for as a pooling of interests even though the transaction represents a taxable exchange for federal income tax purposes. The depreciable assets of the absorbed company are brought forward at their depreciated cost, which may be considerably less than fair value. In addition, the depreciation for tax purposes exceeds that recorded in the accounts; thus, the income of the combined companies includes the effect of both the lower depreciation and the "flow through" of the tax benefit from higher depreciation.

Differences in Effect of Alternative Accounting

The combination several years ago of two substantial publicly held businesses, one clearly the larger and continuing company, provides a typical illustration of the possible differences in the amounts reported in financial statements which can result from the acceptable alternatives which exist in accounting for business combinations today. The facts surrounding the combination are matters of public information and the accounting followed is in accord with present generally accepted accounting principles. The names of the constituents are omitted in the discussion.

The combination was effected by the issuance of ABC's common stock in exchange for XYZ's stock at a ratio of .6 share of ABC stock for each share of XYZ stock. The book value of the net assets of XYZ was approximately $27,000,000. For purposes of this example, let us assume that the book value of XYZ's net assets approximated the fair value of its separable resources and property rights.

The market value of the ABC stock issued for XYZ stock was about $77,000,000, measured in terms of the quoted market price of ABC stock when the transaction was announced. At the time stockholders of ABC and XYZ approved the transaction several months later, the market price of ABC's stock had risen and the market value of the stock issued for XYZ was $91,000,000. The amount assigned to goodwill under purchase accounting would be:

	Based on	
	Market Price at Date Transaction Announced	*Market Price at Date of Stockholders' Approval*
Market value of ABC stock issued	$77,000,000	$91,000,000
Fair value of net assets of XYZ, excluding goodwill (assuming fair value equals book value)	27,000,000	27,000,000
Goodwill	$50,000,000	$64,000,000

The transaction was treated as a pooling of interests and the capital stock and surplus were combined as follows:

	ABC	*XYZ*	*Combined*
Capital stock	$16,500,000	$ 7,600,000	$ 20,000,000*
Capital surplus	55,100,000	9,000,000	68,200,000*
Retained earnings	28,200,000	10,700,000	38,900,000
Total	$99,800,000	$27,300,000	$127,100,000

* After adjustment for exchange of stock.

The market price of ABC's stock at the time of stockholders' approval may have reflected the circular effect of investors projecting earnings on the basis of pooling of interests rather than purchase accounting. Therefore, for illustrative purposes, let us assume as goodwill the $50,000,000 based on the market price when the transaction was announced. The difference in capital stock and surplus after the merger under pooling of interests as compared with that under purchase accounting is:

	Pooling	*Purchase*
Capital stock	$ 20,000,000	$ 20,000,000
Capital surplus	68,200,000	128,900,000
Retained earnings	38,900,000	28,200,000
Total	$127,100,000	$177,100,000

Total equity under purchase accounting is $50,000,000 greater, the amount of goodwill. The retained earnings of XYZ of $10,700,000 is added to capital surplus under purchase accounting but is combined in pooling of interests accounting with retained earnings of ABC.

Under pooling of interests accounting, assuming no general change in operating performance of the constituents, the earnings per share reported by ABC would continue at about the same level as before the combination. If the goodwill under purchase accounting (assuming, as stated earlier, that the book value and fair value of XYZ's net assets, excluding goodwill, were equal) were not amortized, reported earnings would be the same as under the pooling treatment. If the goodwill were amortized, the reported earnings could be affected significantly.

The two methods of accounting could result in completely different prospective reported earnings. The nonrecognition of goodwill under pooling of interests accounting would mean that prospective earnings would not be charged with goodwill amortization. In the absence of any changes in post-combination operating charges, reported earnings would be the aggregate of ABC and XYZ earnings. The recognition and amortization of goodwill under purchase accounting would affect prospective income statements. The extent of the impact on the otherwise combined earnings would depend on the amortization period selected for the goodwill. Assuming that goodwill were amortized over a period of ten years, and with everything else remaining equal, the *earnings per share* reported by ABC under purchase accounting would be only a little more than half of those reported by that company before the merger; and, if the amortization period were eighteen years, the *total earnings* of the resultant enterprise for those eighteen subsequent years would be the same as that of ABC without the merger.

The two methods of accounting may present completely different pictures of growth. Under pooling of interests, the income statement of the combined companies for the current and prior periods would include operating results of both ABC and XYZ. Under purchase accounting, the income statement of the combined companies for the current period would include operating results of XYZ only after the combination and be compared with statements of ABC's operations alone in prior periods.

The magnitude of the differences in the financial information which can be reported by a business, depending on which of two different but acceptable alternatives of accounting is used, detracts from the usefulness of financial statements. The decisions by managements and stockholders to approve or reject a proposed combination might well depend on the accounting method followed. In fact, it is likely that many of the business combinations in the United States, both large and small, in the last ten years would not have occurred if purchase accounting and amortization of the resulting goodwill had been required. What this may indicate is a matter for conjecture. However, it should be clear that the accountant's role should be to provide appropriate financial information on which sound decisions can be made, rather than for decisions to depend on the availability of a favorable alternative accounting method.

The accounting alternatives have also influenced the form of the consideration in some combinations—the use of stock rather than cash. The selection of the form of consideration should be based on economic and business factors and not on accounting methods.

Summary of Current Alternative Practices

The alternative accounting practices considered to be acceptable in accounting for business combinations today and a comparison of some of the results of the alternatives are summarized as:

1. Purchase accounting is acceptable in substantially every business combination. Under purchase accounting, the net assets of the acquired company are accounted for at the fair value of the consideration given or of the assets acquired, whichever is more clearly discernible. Several alternatives in the accounting for goodwill under purchase accounting exist:

   a. Goodwill should be amortized to income over its limited life, if reasonable evidence exists that its life is limited.
   b. Goodwill may be amortized to income over an arbitrary period even though no specific indication exists of loss of value or of limited life.
   c. Goodwill may be retained as an asset unless a limitation of life or a loss of value is indicated.
   d. Write-off of goodwill should be classified as an extraordinary charge to income if it represents a loss of value due to unusual events or developments during the period and the loss is material.[15]
2. Pooling of interests accounting is acceptable for most business combinations in which voting stock is issued as a major portion of the consideration. Pooling of interests

[15] See footnote 1 on page 3.

accounting does not require adjusting assets and liabilities to fair value at the date of the transaction; rather, book values of the constituents are carried forward in the accounts of the combined company.

a. When a business combination accounted for as a pooling of interests is viewed in terms of purchase accounting, the excess (including goodwill) of the fair value of the stock issued over the book value of the net assets acquired is charged to capital surplus or, to the extent capital surplus is not available, to retained earnings.

b. Under pooling of interests accounting, the retained earnings of the constituents are combined and carried forward in the accounts of the continuing company. Under purchase accounting the amount of the retained earnings of the acquiring company only is carried forward.

c. In presenting the operating results under pooling of interests, the current period and all prior periods are treated on a combined basis; under purchase accounting, the operating results of the acquired company are included only from the date of acquisition. The difference between the two methods can result in a significant effect on the trend in earnings of the continuing company. Presentation is particularly confusing when some acquisitions are accounted for as purchases with earnings included only since acquisition and other acquisitions are treated as poolings with earnings included for all periods presented.

d. The fictional aspects of pooling of interests become particularly evident when the capitalization of the combined entity is presented in balance sheets for dates prior to the combination or when such capitalization is used to compute earnings per share for such prior periods. Actually the current capitalization did not exist previously and probably would not have existed even if the companies had been combined earlier. Carrying the current capitalization back under the pooling concept can produce weird results.

3. Business combinations may also be accounted for as partial poolings and partial purchases when the consideration consists of both cash and stock. (When some of the assets, such as property, are partially revalued and a portion of the goodwill is recognized, the accounting leads to hybrid results that can be characterized only as "ridiculous.")

4. Sometimes treasury stock acquired for cash is issued in a transaction and the transaction is treated as a pooling. Other ways have been devised to, in effect, use cash in an acquisition and still achieve a pooling of interests through the illusion of issuing stock.

This discussion of existing accounting practices clearly indicates that accounting for goodwill and the question of the propriety of both pooling of interests and purchase accounting are interwoven and must be considered as one problem.

Effect of Federal Income Tax Treatment

Goodwill is generally recognized, to the extent it has a basis for federal income tax purposes, as a capital asset. When a business, or a segment thereof, is sold or abandoned the tax basis of the related goodwill developed prior to March 1, 1913, or the cost of goodwill purchased subsequent to that date, enters into the determination of the capital gain or loss resulting from the sale or abandonment. Regulation 1.167(a)-3 under the Internal Revenue Code of 1954 does not allow amortization of the cost of goodwill as a deduction for federal income tax purposes. The history leading to the present regulations is reviewed briefly.

The Revenue Act of 1909 contained a provision for "a reasonable allowance for depreciation of property, if any." Goodwill was not mentioned specifically. The Revenue Act of 1913 deleted the word "depreciation" and the revised provision (modified only slightly by the 1916 Act) permitted "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade." Early regulations recognized the interpretation of the word "depreciation" in the 1909 Act and allowed depreciation, although provision was not made for a deduction for obsolescence.

The Revenue Act of 1918 retained the wording of the 1913 Act but added the words "including a reasonable allowance for obsolescence." Still there was no mention of goodwill. Article 163 of Regulation 45, promulgated by the Treasury Department, construing the Revenue Act of 1918, contained:

> Depreciation of intangible property.—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner.

After Regulation 45, the Bureau of Internal Revenue recognized for a time deductions for obsolescence of goodwill, but the taxpayer had the burden of proof for the period of claimed obsolescence.

In the regulations under the Act of 1928, the sentence "No deduction for depreciation, including obsolescence, is allowable in respect of goodwill" was added. The substance of this sentence is contained in present regulations but has never been enacted into the Code.

In each of a number of cases over the years involving the amortization of goodwill, the taxpayer has been denied a deduction. Regulations under the 1939 Code limited obsolescence to physical property. Regulations under the 1954 Code, while not limiting obsolescence to a physical property, contemplate a determinable useful life that is predictable as for depreciable assets.

5

Effects of the Form of Business Combinations on the Accounting

Stock vs. Cash

Those who consider that both pooling of interests and purchase accounting are appropriate methods, depending upon the circumstances, view combinations effected by the exchange of voting stock as transactions differing in substance from combinations effected by the payment of cash, exchange of other assets, or the issuance of debt (all referred to as "cash" in this chapter). They consider combinations effected by stock as mere trading of ownership interests, events which occur outside the entities involved in the combinations. They contend, therefore, that no real purchase or sale of assets occurs, and consequently that no new basis of accountability arises. Thus, the assets, liabilities, and equities should simply be combined in what is called a pooling of interests.

For those who believe that pooling of interests is a proper accounting method, the criterion of stock or cash has become the only real basis for distinguishing between pooling of interests and purchase transactions. The resulting questions that need to be answered with respect to poolings relate to the accounting in marginal situations when, for example, a combination is effected with treasury stock, preferred stock, or partly cash, or a minority interest in a constituent company arises in the combination. In addition, it is not entirely clear whether those who support pooling would prohibit purchase accounting for combinations effected by voting stock, thereby restricting purchase accounting to combinations effected by cash and restricting pooling of interests accounting to those effected by voting stock.

Those who share the views expressed in *Accounting Research Study No. 5* (Appendix A includes comments on *ARS 5*) do not agree that a business combination effected by stock and one effected by cash are different in substance. They contend that the essence of a business combination is the acquisition of the business and assets of one company by another for a certain price, except for those few combinations when neither constituent is clearly dominant in the continuing entity. Cash and stock are considered merely alternative forms of consideration. Those who share this view regard the pooling of interests method of carrying forward the book values of assets, liabilities, and equities of the acquired company as improper, since it fails to record the cost of the assets received as measured by the value of the consideration exchanged.

The alternative methods of accounting for business combinations affect significantly the problem of accounting for goodwill. Under a pooling of interests, the goodwill of the absorbed company is not recognized in the accounts. The discussion which follows considers both sides of the controversy to reach a conclusion on the appropriate accounting for business combinations as a basis for then considering the proper accounting for goodwill.

Combinations with Stock Differ in Substance from Those with Cash. Those who view business combinations accomplished by issuing stock as different in substance from combinations effected by the payment of cash consider pooling of interests an appropriate and logical method of accounting for combinations effected by issuing voting stock.

Our research, including a review of correspondence commenting on *ARS 5*, discloses the following principal arguments to support pooling of interests accounting:

1. Nothing of substance requiring a new basis of accountability and no exchange transaction in the usual sense occur. The combination is simply a continuance of two or more businesses formerly conducted separately; therefore, the assets, liabilities, and equities should be combined on

the same basis as they were carried in the accounts of the constituents. The exchange occurs outside the existing accounting entity, and the ownership interests of the constituents continue in the combined company.

2. Often in the exchange of shares, managements are not concerned with the fair value of the assets of either constituent or with the aggregate market value of the shares issued. Stockholders are concerned with the earning power (and attendant growth in value and dividend-paying ability) of their investments, and those who negotiate the combination are primarily concerned with arranging terms which assure insofar as possible that earnings per share on the new number of shares at least equal those on shares outstanding before the combination.

3. Adjusting the assets of one company to current values and not adjusting the assets of the other constituent to the combination is not logical. No cash has been paid for any assets and recognizing a new cost is not required.

4. The market price of the shares issued in a business combination at a particular point in time is not necessarily a proper measure of the value of the assets and businesses coming into the combined company. Market prices of stock may fluctuate widely, often for reasons completely outside the immediate environment and circumstances of the constituent companies.

5. The recognition of goodwill by the resultant business entity—goodwill which can be measured only as a difference between the fluctuating market price of stock and the aggregate fair value of the separable resources and property rights less liabilities of the absorbed company—is particularly objectionable.

6. In a combination effected by stock, the earnings of the resultant company should not logically differ from the combined earnings of the predecessor companies because new values are assigned to the assets of those companies.

Furthermore, the recognition of fair values of tangible assets, specific intangibles, and goodwill when stock is issued may result in a double reduction in earnings per share, (a) one resulting from the possible dilutionary effect of an increase in outstanding shares and (b) the other resulting from the amortization of increased asset values and the amortization of goodwill if that alternative practice is adopted.

7. The market price of stock issued may be based on the opinions of investors as to future earnings resulting from the combination. Thus, goodwill recognized in a combination may have been created by the transaction itself rather than by the prospects of future earnings without the combination.

8. Pooling of interests accounting is consistent with the theory of reorganization underlying provisions of the Internal Revenue Code. The substance of the theory is that both ownership groups form the new entity, no income is realized, and the bases of assets are not increased.

Combinations with Stock Do Not Differ in Substance from Those with Cash. Those who view business combinations effected by issuing stock as no different in substance from combinations effected by the payment of cash do not consider pooling of interests a proper method of accounting for combinations.

The principal arguments advanced by proponents of this position are:

1. Stock issued to effect a business combination is a form of consideration to be valued just as much as if cash were paid or other property exchanged.

2. Most business combinations effected by either issuing stock or paying cash involve a constituent which is clearly the continuing entity; and the substance of the transaction is that one company continues, taking over the business and assets of the other.

3. Purchase accounting adjusts the assets of one company to current values without similarly adjusting the assets of the other. However, this procedure is no more objectionable when stock is used than when cash is used. Further, the problem of "heterogeneous" costs exists

throughout financial statements today. For example, a company records a new plant at current costs and continues to carry existing plants at their original costs.

4. Depreciation charges contain a mixture of old and new costs. However, this problem is not limited to accounting for business combinations but is common to assets acquired in all kinds of business expansion.
5. Business combinations, whether for stock or cash, are the means by which the continuing company expands and grows. The principles of accounting for expansion and growth through business combination should be the same as those for expansion and growth from within.
6. Goodwill acquired in a business combination is a fact and represents a part of the total cost which must be accounted for by the continuing company. To argue that the market price of stock is not a reliable indicator of total values exchanged is improper. Values have no existence except in the minds of those who make exchanges, and the prices at which the exchanges occur measure those values.

Appraisal of Viewpoints

General Pattern of Business Combinations—One Constituent Company Is Dominant. Our experience with many business combinations indicates that most combinations include a constituent company which is the dominant continuing entity. The conclusion of *ARS* 5 is the same.

The distinction as to which constituent in a combination is the dominant and continuing entity should not be determined by legal designations. The acquisition of a small company by a large one accomplished through a merger of the larger company into the smaller one and the use of the smaller company's name for the resultant enterprise does not change the fact that the larger enterprise is usually the dominant and continuing entity. The fact that the relative size of the constituents is similar (in terms of assets, revenues, earnings, total values, number of stockholders, etc.) does not necessarily indicate that one is not the dominant and continuing entity. Most often the continuing entity is the one whose management takes control. However, all of the facts and circumstances must be considered. Usually a common sense evaluation will identify the continuing entity without much reasonable doubt.

Starting with the premise that one constituent of a business combination is the continuing entity and putting aside for the moment those relatively rare combinations to which the premise does not apply, are those business combinations effected by stock and those effected by cash different in substance—a difference so significant as to call for a completely different basis of accounting?

Substantially All Business Combinations Are Purchases. We can find no significant difference in substance between those business combinations effected by stock and those effected by cash. Without a substantive difference in the nature of the transaction, we find no reason for basic differences in the accounting simply because the form of consideration differs.

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.

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.

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 of the continuing company increase, though the forms of 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.

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.

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.

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.

Combinations When No Constituent Emerges as Continuing Entity. In a few business combinations no constituent can be identified as the continuing entity. The relative size of the constituents is similar and the managements of both become completely integrated at high levels. How can it be said that one of the constituents survives the other? The combination, in those instances, results in the creation of a new enterprise arising from the total integration of all factors: the assets, the operations, the management, and the stockholders. When a number of companies are combined through a series of closely related transactions, the continuing entity may also be a "new enterprise" rather than an expansion of one of the constituents.

In the type of business combination described in the preceding paragraph, all of the stockholders have traded their interests for interests in a new company, calling for a new basis of accountability. Thus, the accounting for the combination should be similar to that followed for new business enterprises. Only a minor portion of business combinations are of this nature, and the emphasis in this study is on the more usual combination involving a continuing entity.

The accounting for the assets of a new business is generally established at their cost to that new business, measured by the fair value of the shares or other consideration given in the exchange or by the fair value of the assets received, whichever is more clearly discernible. New businesses ordinarily do not capitalize goodwill values which may exist or arise in the formation of the business.

Effect of Tax Bases. If poolings of interests were eliminated and purchase accounting were adopted for business combinations effected by tax-free exchanges of securities, a question would arise as to accounting for assets whose values exceed their tax bases.

The value of an asset to an acquiring company is diminished if a portion of the cost is nondeductible for income tax purposes. However, the nondeductibility of certain costs would be one factor considered by the acquiring company in establishing the amount of consideration given—the company would recognize the future tax effects of the income tax bases of the assets acquired. Thus, the total consideration given must be viewed as having recognized future tax effects. Otherwise, the assumption would be that the transaction was not conducted by rational and informed individuals, an assumption which cannot be justified.

The income tax bases of the separable resources and property rights acquired should influence the allocation of the total purchase price of the acquired company among the various assets and liabilities. The effect of the tax basis should be determined and recognized in assigning a portion of the purchase price to the various items. The effect of a lower tax basis for a specific item should be deducted from the value which would otherwise be assigned to the item. The net effect of the deductions in turn affects the amount which would otherwise be assigned to goodwill.

Effect of State Laws. A question arises in applying purchase accounting to transactions which qualify as statutory mergers under certain state laws that provide for the carryforward of recorded book values of the constituents. Statutory mergers are a legal matter and relate primarily to the question of the availability of surplus for dividends, information as to which is frequently significant enough to require disclosure. However, the laws should not control the determination of the equities in a company, including the amount of retained earnings, for a fair presentation in the financial statements.

Laws generally follow practice, and accounting practices have given rise to many existing laws. Laws are enacted on the assumption that the practices followed or endorsed by a profession or responsible group (such as medicine, engineering, or accounting) are the proper ones. If the practices are discovered to be erroneous or outdated, they should be changed; the laws follow the changes and are more or less continuously updated to reflect the practices in effect.

Pooling of Interests Inappropriate. Our conclusions agree with those expressed by Wyatt in *ARS 5*—that business combinations are purchase transactions, that pooling of interests is not a proper method of accounting for combinations, and that the accounting for those relatively few business combinations which do not involve a clearly continuing entity should follow that accorded new business enterprises.

We do not agree with the conclusion expressed by Holsen in the addendum to *ARS 5* that business combinations effected by stock differ in substance from those effected by cash and that they require different bases of accounting. However, Holsen recognized in his brief discussion of the problem some fundamental questions about accounting for goodwill which suggest that existing practices may require substantial change.

The conclusions concerning the inappropriateness of pooling of interests accounting lead to the corollary that the "nonaccounting" for goodwill which is a result of pooling accounting is also inappropriate. The primary basis for this conclusion lies in the weakness of the pooling of interests concept and is also supported by the facts that under pooling accounting (1) no attempt is made to arrive at any fair measure of the goodwill value and (2) no disclosure exists as to the absence of accounting for goodwill.

6

Accounting for Nonpurchased Goodwill

Goodwill value is the result of innumerable factors, some of which may reflect direct efforts and expenditures of a company and some of which may not. As discussed in Chapter 2, goodwill has certain characteristics which generally distinguish it from other elements of enterprise value. Notably, goodwill is a value which attaches only to a business as a whole; it is a reflection of the views of investors regarding the future earnings prospects of the business—its earning power.

Accounting practice has long recognized goodwill value as an asset only when it has been acquired by bona fide purchase of a business entity, and then only at the amount actually paid for it. However, goodwill value exists with respect to a business and the characteristics which distinguish goodwill from other elements of enterprise value apply, whether or not that business is ever absorbed in a business combination. Thus, considering the propriety of present practices of accounting for nonpurchased goodwill may provide some clues to the proper method of accounting for goodwill in a business combination.

All major expenditures (such as those for research and development) designed to create specific intangible values are not accounted for in the same manner, but generally neither nonpurchased goodwill value nor the expenditures incurred to create goodwill are reflected as assets.

Accounting for the Value of Nonpurchased Goodwill

Should a company capitalize the total market price of its outstanding stock, thereby recording its entire goodwill value as an asset? And, should the goodwill then be amortized to income, especially if its value diminishes?

Reasons Generally Given for Not Capitalizing Nonpurchased Goodwill. Accountants substantially agree that the nonpurchased goodwill value of a company should not be accounted for in the manner suggested by the questions in the preceding paragraph. The reasons most commonly cited for nonrecognition of goodwill value in the accounts are (a) conservatism, (b) absence of basis for determining the value, and (c) the cost basis of accounting.

A conservative viewpoint in evaluating uncertainties and risks in a business may prove useful in resolving practical problems and in proper perspective can exert a useful influence on accounting theory. However, supporting a deliberate nonrecognition of values in the guise of conservatism is not a proper extension of the conservative viewpoint.

Objective bases may exist for determining the value of the nonpurchased goodwill of a business at any point in time. The value of a publicly held business enterprise is appraised continually in the marketplace, and the composite appraisal of many investors is reflected in the market price of the company's stock. Objective determinations of the total goodwill value of a company are also achieved when a business sells a significant number of additional shares of its stock for cash or purchases substantial blocks of its outstanding stock.

As discussed in Chapter 3, the cost basis of accounting, a corollary of the realization principle of recognizing revenue, is a convention used in accounting to serve the financial statement objective of presenting information about the values of the separable resources and property rights of a business. When this objective can be better served by abandoning the cost method, other methods should be adopted in accounting, such as percentage-of-completion accounting for long-term construction contracts and market values for securities owned by investment companies. Otherwise, accounting conventions created to serve financial statement objectives assume precedence over those objectives. Thus, citing the cost basis of accounting as a reason for not recognizing nonpurchased goodwill value has little validity, for it addresses itself to methods rather than to objectives.

Thus, the reasons (conservatism, absence of basis for determining value, and the use of the cost basis in accounting) most commonly cited for not recognizing nonpurchased goodwill value are insufficient to support the accounting practice. The propriety of nonrecognition must be assessed in terms of financial statement objectives and in the light of the characteristics of goodwill.

Present Practices Serve Financial Statement Objectives. Financial statements should provide information which investors can use in appraising the value of a business enterprise—in deciding on prices at which its stock should be traded. Regardless of how investors use that information or how significantly it influences their opinions, the essence of the role financial statements play in investor decision-making is to provide information regarding the value of the separable resources and property rights (principally on the cost basis) of a business. Most significantly, financial statements provide information regarding increases in resources and property rights—that is, the profits or earnings of the business.

Innumerable intangible factors and conditions other than separable resources and property rights contribute to the profitability of a business, but accounting generally provides no information on those factors and conditions other than the earnings which they help achieve. Investors then appraise the potential earning power of a business and determine the value of the entire business, including its goodwill.

Capitalizing the value of a company's internally developed—nonpurchased—goodwill and amortizing it against earnings thus appear to conflict directly with financial statement objectives today. Under a capitalization and amortization procedure the balance sheet would simply tell the investor what the investors' opinions were concerning future earnings expectations. The income statement would include amortization of the capitalized goodwill, thereby reducing current income by some portion of past expectations of future earnings. The information provided would not serve the needs of the investor in making investment decisions and could only confuse or mislead him.

The following thoughts expressed by J. M. Yang reflect a perception of the consequences of allowing the value of nonpurchased goodwill to be recognized in determining financial position and earnings.

> Were it possible for all forms of values in the possession of a business to be capitalized as assets, including valuable considerations of every conceivable kind, the income of that business might be

> reduced to an insignificant amount. . . . Under such circumstances accounting would dwindle into comparative insignificance.
>
> On account of this, it becomes particularly important in accounting to segregate the class of values which are fairly definite in character and upon which definite value equivalents are expected, from those values which are indefinite and incommensurable and upon which a mere chance of getting their equivalents exists. To the former belong the investment assets of various kinds and to the latter the values that are to be allowed as increments of income only as they come into the business in definitely measurable units like cash and receivables.[1]

Present Practices Measure Earnings. If a business enterprise were to determine a value for its nonpurchased goodwill, capitalize that value, and amortize it to income, the income statement of the business enterprise would not show the success of that enterprise in achieving earnings, but rather would tend to show some type of "normal" earnings. Under this procedure a value would be ascribed to the superior earning power of the enterprise, and the value would then be amortized to income which would be used in future determinations of that value. Any superior earning power of the enterprise would be eliminated by amortization of the goodwill recognized, and the resultant earnings would tend to indicate a "normal" return.

A capitalization procedure whereby asset values are adjusted for nonpurchased goodwill would reduce the rate of return of the most prosperous company to the level realized by a representative one. The result would be an apparent uniformity of earning power although no uniformity exists.[2] Thus, the usefulness of financial statements to the investor in assessing the relative profitability of business enterprises would be substantially reduced.

Various accounting writers have recognized the lack of logic in a capitalization-amortization procedure of accounting for nonpurchased goodwill value. Paton stated that, "Any accounting procedure which resulted in eliminating the periodic fluctuations in income in the specific business, or in equalizing the rates realized by different competing enterprises, would be quite unreasonable."[3] George O. May stated the issue succinctly:

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[1] *Goodwill and Other Intangibles*, 1927, pp. 133-134.
[2] William A. Paton, *Accounting Theory* (1922), Reprinted, 1962, p. 318.
[3] *Ibid.*

> A system of accounting which attempted to reflect changes in the value of an income stream in the determination of income would create an insoluble problem of circular reasoning.[4]

Yang also observed:

> It must be emphasized here that the recognition of intangibles through the capitalization of net income is especially to be condemned because such a procedure would tend to destroy the essential purpose of accounting as a barometer of business efficiency.[5]

As stated previously, goodwill value reflects investor attitudes about a company's earning power. Earning power is prospective in nature in that it implies an evaluation of a rate of earnings in future periods; it may be designated as potential income, or at least the probability of potential income.[6] For an enterprise to recognize in its accounts the capitalized value of a part of its probable future earnings is neither rational nor practicable.[7]

A separate disposal of goodwill is impossible, since it is inseparable from the business as a whole. Changes in value of many assets can be realized readily and without materially affecting or seriously disorganizing the status of an enterprise. Goodwill value cannot be realized in that manner. Even if recording changes in the value of goodwill were otherwise permissible, realizing those values could come only through subsequent earnings or through disposal of the business as a whole.

Cost of Nonpurchased Goodwill

Should a company capitalize expenditures which may result in goodwill value being ascribed to the business enterprise?

Expenditures of money and effort necessary to bring together an effective working force, to provide desirable working conditions resulting in a creative and harmonious environment, and to create a favorable corporate image may contribute to the goodwill of an enterprise. In fact, many expenditures create future earnings benefits which may be reflected in increased goodwill value.

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4 "Business Combinations: An Alternate View," *Journal of Accountancy*, April 1957, p. 35.
5 *Op. cit.*, p. 136.
6 *Ibid.*, p. 115.
7 Paton, *op. cit.*, p. 320.

An attempt to capitalize and amortize the expenditures which create goodwill value would be extremely difficult if not impossible. Which particular expenditure resulted in the creation of goodwill value? In what period are income benefits received? Recording amounts which purport to reflect the cost of goodwill would usually be based on arbitrary and indefensible allocations.

As discussed in Chapter 2, goodwill value is subject to sudden fluctuations and has no predictable relationship to its cost. Goodwill value cannot be measured in terms of dollars spent in an attempt to create it. The goodwill value derived from specific expenditures may not become apparent until several periods after the expenditure; even then identifying goodwill value with specific factors or expenditures is generally impossible. Thus, attempts to capitalize expenditures would not be useful in providing meaningful information on the resources and earning power of a business.

Yang stated that it might seem to be sound accounting procedure to set up as an asset the difference between the cost of maintaining the current status of the business and that of building up or improving future earnings and to write off this value over the period of years to which it may apply.[8] Yang acknowledged the impracticability of the proposition, saying:

> It must be stated in answer to such a proposal, however, that the task of differentiating between a current expense and a capital investment in instances of this kind is extremely difficult. Particular expenditures in advertising, for example, can scarcely be apportioned between their present and future influences on trade. Goodwill is primarily the result of satisfactory service. It is a growth and not a static phenomenon. Costs incurred in one period may be responsible for the beginning of such a growth, but it may be that the same expenditures will have to be made in the future in order that the satisfactory relationship may be maintained. . . .
>
> It is evident that the main source of difficulty in the accounting treatment of this class of expenditures lies in the indefiniteness of their effect on the earnings of a business. It is quite beyond the genius of the accountant to make any definite allocation of the effect of such costs.[9]

[8] *Goodwill and Other Intangibles,* 1927, p. 147.
[9] *Ibid.,* pp. 147-148.

A comment by Sands in his discussion of questions involved in accounting for intangibles is pertinent to the problem discussed here:

> Accounting will be at its maximum utility only if accountants do not attempt what is impossible, do attempt as much as is possible, and make clear the significance of what they do. Not attempting the impossible entails not trying to measure intangibles. . . .[10]

Recommended Accounting

Our conclusion is that neither the value of nonpurchased goodwill nor expenditures incurred to create goodwill should be capitalized and amortized against future earnings. Thus, we recommend that the present practices in accounting for nonpurchased goodwill be continued.

[10] J. E. Sands, *Wealth, Income, and Intangibles,* 1963, p. 82.

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Cost of Purchased Goodwill

74 A conclusion in Chapter 5 of this study is that business combinations are purchase transactions except for those relatively few combinations which result in a new business enterprise. Therefore, the accounting principles and rules applied to other kinds of purchase transactions should generally govern the accounting for business combinations. However, in view of the characteristics which distinguish goodwill from other elements of value in a business, the proper method of accounting for the goodwill purchased in a business combination may differ from that which should be accorded the separable resources and property rights of the business acquired. The question of determining the cost of the goodwill acquired in a business combination should be considered before the question of the proper accounting for purchased goodwill.

Determining Purchase Price of Business Acquired

In accounting for a business combination as a purchase transaction, the total cost of the purchase must be determined before the cost can be allocated appropriately to the various assets acquired. Under existing accounting concepts, if cash is paid, the total cost of the assets is the sum of the cash given plus the liabilities assumed. If the consideration is other than cash, the total cost of assets, after considering the liabilities assumed, is either the fair value of the consideration given or the fair value of the consideration received, whichever is the more clearly evident.[1]

The determination of the total price to be paid for a business enterprise results from negotiations between the parties and represents primarily an assessment of its earning power. The various resources and property rights of a business are important factors considered in negotiations and their values are susceptible to individual measurement. However, various intangible factors (goodwill) which are favorable to a business, contribute to its earning power, and attach only to the business as a whole are not susceptible to individual measurement. Thus, the total value of the consideration given, whether in cash or another form, is generally more "clearly evident" and measurable than the individual elements of value of the business acquired and, therefore, ordinarily represents the best measure of the total cost.

In a combination effected by stock, the price paid should ordinarily be measured by the fair value of the stock issued, as determined at the date the agreement on final terms is reached. The fair value of the stock issued must necessarily consider the market price of the stock, since this represents the value which the stockholders ascribe to the stock.

In many combinations both the fair value of the stock and the number of shares to be issued are agreed upon when the final terms are negotiated to consummate the transaction. In other combinations the fair value of the stock is agreed upon and the number of shares is to be determined by the market price of the shares prevailing at some specified future date. Since the fair value has been agreed on in the combination negotiations, that value represents the amount which management is accountable for in issuing the stock. Stockholders may ratify the combination after the date of agreement, but the terms and the stockholders' evaluation of them determine the stockholders' vote. At times, events between the date of agreement as to terms and the date of stockholder approval may indicate clearly that the value agreed on is not representative of the fair value of the shares issued. In these unusual circumstances, the fair value indicated by the sub-

[1] *Accounting Research Bulletin No. 48*, "Business Combinations," 1957, par. 8.

sequent events may have to be taken into consideration in establishing a basis of accounting for the combination.

The value of the consideration given in a business combination may vary depending on the seller's preference for a particular form of consideration. Many factors can motivate a seller's personal preference as to the form of consideration, and no attempt is made to list the numerous possibilities. Included among them, however, may be immediate needs for cash, desire to postpone taxable income, opinion of the future market conditions, and plans for other elements of his personal business. A rational seller considers the present value of the alternative forms of consideration available to him, as well as other alternatives, and he selects the most attractive terms, including the form of consideration. Although the value of the consideration given may vary depending on the seller's preference as to form, the market price of shares of stock issued remains a valid basis for determining the cost of the business acquired. That 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.

The concepts set forth in the preceding paragraphs for determining
76 the cost to be accounted for in a business combination also apply to transactions effected by share-for-share exchanges. The external factors which affect the market prices of all shares traded normally apply equally to both securities.

If the stock issued in a business combination is not publicly traded or if the stock has a relatively narrow trading base (thin market), other measures of the fair value of the stock may be necessary in lieu of the quoted market prices. Determination of the fair value is not the function of accounting. Ordinarily, fair value may be determined from the computations and records on which the purchase negotiations are based or from opinions of persons competent in making value determinations if the evidence from the negotiations is not clear.

Allocating Purchase Price of Business Acquired

After the total price paid for an acquired business is determined, the price (cost) must be allocated to the separable resources and property rights and goodwill. If the acquired business continues to operate as a separate entity, the same problem of allocation arises in consolidation and is discussed in Chapter 9.

Separable Resources and Property Rights. The purchase price should be allocated to the various resources and property rights on the basis of their fair values at date of acquisition. The allocations must consider the income tax bases of the resources and property rights to the continuing company. The costs of the assets to the acquired company or the amounts at which the assets are carried in the accounts of that company at date of purchase are not proper bases for allocation unless the costs or carrying amounts coincide with current fair values or represent the best available evidence of the current value to the continuing enterprise. However, the accounting practices followed by the acquired company should be reviewed to determine any differences from the accounting followed by the acquiring company or continuing enterprise, and differences should be adjusted appropriately or recognized in allocating the purchase price.

The objective of the principle of allocation is clear. Every effort should be made to identify and account for the economic facts and values inherent in the transaction. Applying the pooling accounting method fails to provide accounting recognition of the asset values acquired and of the basic economic consequences of the transaction.

A discussion of all the problems associated with determining the fair values of the separable resources and property rights acquired is beyond the scope of this study. Although the problems are complex, the determinations must be made in each situation if the economic facts are to be accorded fair accounting recognition.

Purchased Goodwill. The amount by which the price paid for the business as a whole exceeds the total fair value of its separable resources and property rights, including those intangible rights and resources which are identifiable and separable, less any liabilities assumed, represents the amount paid for and allocable to goodwill. This is the only meaningful measure of the amount paid for goodwill. As discussed in Chapter 2, goodwill is the aggregate of those several intangible factors and conditions which contribute to the earning power of the business and affect the value of the business as a whole. The intangible factors and conditions, while not separable from the business as a whole, add value to the business over and above the values of the separable resources and property rights.

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Accounting for Purchased Goodwill

After the cost of goodwill purchased in a business combination has been determined, the problem remains of accounting properly for that cost. This chapter examines alternative methods of accounting for purchased goodwill in light of the conclusions in previous chapters regarding (a) the characteristics which distinguish goodwill from other elements of value in a business, (b) financial statement objectives and accounting conventions and concepts, and (c) the proper accounting for nonpurchased goodwill.

Summary of Current Accounting Practices

The alternative procedures currently considered acceptable in accounting for purchased goodwill are set forth in Chapter 5 of *ARB 43*, as modified by *APB Opinion 9*, and the evolution of those practices is described in Chapter 4 of this study.

In summary, the practices require that purchased goodwill be capitalized as an asset (except under pooling of interests accounting which, in effect, results in nonaccounting for goodwill). To the extent that management decides that purchased goodwill may continue to have value during the remaining life of the business, the cost of goodwill may continue to be reported as an asset. If management decides that goodwill which has been capitalized may not continue to have value during the entire life of the enterprise, the cost of goodwill may be amortized to income. Goodwill may be amortized even though no evidence exists to indicate a loss of its value or limit to its life. Likewise, amortization may be recognized even though expenditures are made to maintain the value of the goodwill capitalized. Thus, amortization of purchased goodwill is optional in most cases.

Existing accounting practices require that purchased goodwill which, initially or in subsequent years, is recognized to have limited life be amortized to income (before extraordinary items) over that life, or it may be written off or written down as an extraordinary item if the loss of value is deemed to have resulted from unusual events or developments during the period and the amount of loss is material. (See footnote 1 on page 3 for the effect of *APB Opinion 9* on direct charges to retained earnings.)

Finally, we note again the widespread current practice of accounting for business combinations as poolings of interests. Under this concept no accounting recognition is given to goodwill acquired, since no purchase is deemed to occur. If analysis of the economic facts indicates that goodwill does exist in a business combination accounted for as a pooling, the absence of accounting recognition of the value represents in effect a method of accounting for goodwill—nonaccounting. Our conclusions as to the lack of propriety of the pooling concept and its resultant effect on accounting for goodwill are presented in Chapter 5.

Some of the arguments commonly given by accountants to support the recognition of purchased goodwill as an asset and the subsequent amortization of the goodwill are summarized in the following paragraphs. Our evaluation of these arguments is presented subsequently.

Arguments for Recording Purchased Goodwill as an Asset. Goodwill of the absorbed company in a business combination has been paid for; accountants must presume that the continuing company received value for the consideration given, and therefore the value of goodwill should be recorded as an asset. Under this view those characteristics or attributes of goodwill which distinguish goodwill from other assets are less significant than the similarities between goodwill and other assets. An expenditure has been made, a portion of it is identified as goodwill, and accounting recognition of the goodwill value as an asset is appropriate.

A corollary of that argument is that the amount recognized as goodwill should continue to be reported as an asset until evidence arises that its value has diminished. Amortization over an arbitrary period is viewed as unsupportable in the absence of evidence that goodwill has been consumed or has suffered an impairment in value. Since that evidence is generally difficult to establish for a going business, goodwill capitalized would seldom be amortized.

Another argument is that the financial statements cannot show an investor the return on investment which a company has achieved unless amounts paid for goodwill are recognized as an asset. Rate of return analysis is a meaningful technique, a measure of managerial performance which should include all elements of both the return and investment to prevent misleading interpretations. The return of a period should not be affected by arbitrary amortization of goodwill in the absence of evidence that the value of goodwill is impaired. Likewise, the investment base should not omit expenditures which remain unconsumed or unimpaired at the end of a fiscal period.

Arguments for Amortizing Purchased Goodwill. The earnings of a company are not stated properly unless all costs are deducted from related revenues. Unless amounts paid for goodwill in a business combination are charged to future earnings, such earnings of the continuing company are overstated. Under this view goodwill is similar to most other assets of a business and is assigned to future time periods either in relation to the manner in which it is utilized or consumed or in some other manner which produces a fair pattern of charges to income. The negotiation proceedings which lead to the final exchange price in a business combination may indicate the most appropriate basis for amortizing the cost of goodwill. Since goodwill is a cost incurred in anticipation of future earnings, the cost should be amortized in the periods of those future earnings. If goodwill is not amortized, the future income statements fail to include all costs incurred to generate future revenue.

Purchased goodwill should be amortized since it is difficult to establish the continued existence of goodwill at a later date. Even if goodwill continues to exist, the goodwill is undoubtedly "new" goodwill created by efforts and expenditures since the business combination occurred. Goodwill acquired in a business combination represents a value deriving from a specific set of circumstances and the cost should be amortized in a manner consistent with the nature of the circumstances. Later expenditures to create or maintain goodwill should also be accounted for in a manner consistent with the circumstances in which they were incurred. The later expenditures, however, have no bearing on accounting for an earlier expenditure for goodwill.

Evaluation of Concepts of Goodwill Reflected in Current Practices

Present Accounting. The general approach now followed in accounting for purchased goodwill is broadly the same as in accounting for the separable resources and property rights of a business. Thus, purchased goodwill is carried as an asset subject to amortization under various conditions.

The concepts of goodwill which appear to underlie the current practices of accounting for purchased goodwill are that (a) goodwill is an asset whose value is susceptible of separate measurement in periods after its purchase and (b) the period of existence of purchased goodwill can be estimated—that it may be determined to have an unlimited life or an estimated limited life. Those concepts should be evaluated in the light of the conclusions of this study regarding the characteristics of goodwill.

Value of Goodwill After Purchase. Is goodwill an asset whose value is susceptible of separate measurement in periods after its purchase? Unless purchased goodwill can be appraised in this manner, the requirements of *ARB 43*—to carry goodwill as an asset without amortization or to amortize it—cannot be implemented in any rational or informed manner.

Three of the characteristics of goodwill set forth in Chapter 2 are that: (a) the individual factors which may contribute to goodwill cannot be valued; (b) goodwill attaches only to a business as a whole; and (c) goodwill appears to be an element of value which runs directly to the investor in a business enterprise.

As stated in Chapter 3, the function of the balance sheet is to report, subject to the limitations of the cost basis, the values of the separable resources and property rights of the business committed to the production of earnings in the future. A balance sheet does not attempt to show the entire value of a business or all factors and advantageous conditions which may be valuable to an enterprise. Purchased goodwill—the amount recognized in consummation of a business combination—is that portion of the total value ascribed to the absorbed company by investors at the date of combination which is assigned to goodwill when the total consideration is allocated among the separable resources and property rights and goodwill acquired. However, acquired goodwill immediately becomes integrated with the total goodwill of the continuing company. The factors which affect the earning power of the companies as separate business units become combined in a new relationship, as do the factors which affect investors' opinions of the earning power of the individual companies. The value identified as goodwill does not become a separable resource or property right of the surviving business and is not separately identifiable in the surviving business. Thus, after the combination, the goodwill value of the absorbed company identified in the combination loses identity and becomes an integral and inseparable part of the goodwill value of a different business entity.

At times an absorbed company continues as a subsidiary or division on a substantially separate and autonomous basis. The earning power of an acquired subsidiary or division may be identified to a degree, but the level of subsequent earnings is rarely a relevant guide for a recurring valuation of purchased goodwill. Do the separate earnings reflect (a) intangible factors which influenced investor opinion in establishing the value of the purchased goodwill, (b) other factors contributed by the acquiring company, or (c) factors created by the combination? Perhaps the value of the purchased goodwill has diminished or vanished and has been replaced by values developed internally.[1]

Capitalizing and reporting purchased goodwill as an asset embodies the corollary of either amortizing or not amortizing that amount. Amortization suggests that the portion of earning power attributable to purchased goodwill should be identified and deducted in determining net income, even though no evidence exists that its value has diminished. Nonamortization does not affect the measure of earning power, but the goodwill value imputed by the investor from that earning power is unrelated to the goodwill carried as an asset. Thus, each alternative disposition of purchased goodwill which is capitalized as an asset results in earnings data which may be misinterpreted, and knowledgeable investors in appraising a company usually eliminate from the financial statements both purchased goodwill and any related

[1] J. M. Yang, *Goodwill and Other Intangibles,* 1927, p. 195.

amortization. On goodwill as a balance sheet asset, Homer Kripke observed:

> The loss of the goodwill as a balance sheet asset is deemed of no importance, because accountants and financial analysts have come to regard such "intangibles" with suspicion and to automatically disregard them in computing net worth. Lawyers, following the same lead, frequently require the exclusion of intangibles in the definitions controlling the computation of net worth and of balance sheet ratios in indenture restrictions. More importantly, net worth or "book value" itself has lost much of its importance in the securities markets, and value computed from capitalized earnings is the predominant consideration.[2]

One might conclude from a failure to record purchased goodwill as an asset that the amount paid for goodwill has been lost and that the transaction was unwise or improper. That conclusion is not valid. To help illustrate this point, consider the accounting for an issue of stock by an established company for cash. Assume that a company has 1,400,000 outstanding shares of stock with a book value of $10 a share ($14,000,000 total book value) and issues 200,000 additional shares for $50 a share, the current market price of its stock. The cash consideration received, $10,000,000, is recorded as an asset. After the sale, the book value of the company's outstanding stock is $15 a share ($24,000,000 book value for 1,600,000 outstanding shares), reflecting the consideration received for the new shares.

Does this situation suggest that the financial statements tell the purchasers of the new stock that their investment is not worth $50, but is worth only $15—that $35 of their investment has been lost? It does not. Rather, the financial statements, in effect, inform the purchasers of the new shares that $35 of their investment is in goodwill (assuming fair value and book value are otherwise equal), representing the present market value of anticipated future earnings. Only if the company were to capitalize the market value of all of its outstanding stock would its financial statements show a book value of $50 a share. This study has concluded that recording the entire goodwill of a company would serve no useful purpose. Yet, the existence and value of goodwill are as objectively established by the issue of stock for cash as they are in the purchase of goodwill in a business combination.

[2] "A Good Look at Goodwill in Corporate Acquisitions," *The Banking Law Journal,* December 1961, pp. 1035-1036.

After a business combination the only relevant investor opinion relates to the combined company as expressed in the market price of that company's stock. Therefore, the goodwill after a business combination is identifiable and measurable only in total for the combined company. Thus, the concept that the value of purchased goodwill is susceptible to measurement in periods after its purchase is not valid and provides no rational basis for deciding whether to carry goodwill as an asset without amortization or to amortize it.

The contention that the amount paid for goodwill must necessarily be recorded as an asset if rate of return analysis is to be meaningful is likewise not valid. Return on investment analysis, it is generally agreed, can be a meaningful concept only if current earnings are measured against the current value (generally, as expressed in the market) of an investment. If goodwill is to be included in the investment base, the rate of return would have to be computed as a ratio of earnings to the total value of a business including all of its goodwill—not only purchased goodwill. The rate of return would then be based on values which the earnings themselves, both past and prospective, have created, and it could not be a measure of profit performance.

84 Financial statements show the investor a ratio of earnings to the value of the separable resources and property rights a company has committed to the production of those earnings to the extent the cost basis is reliable as a measure of those values. However, the investor is primarily concerned with the rate of return on his actual or potential investment—the price-earnings ratio, which relates earnings to the market price of his stock. The financial statements are not intended to disclose that relationship.

Those who advance the argument on rate of return may be concerned with the needs of management for analyses of the success of individual projects or ventures, rather than with the needs of investors for information on the earning power of a business. Venture information, such as the results of specific business acquisitions and specific products, may at times be useful to investors, but it cannot be determined from financial statements designed to show the resources and earning power of the enterprise as a whole. If information of this kind is desirable, it must be presented in special analyses or other forms of disclosure.

Estimated Life of Purchased Goodwill. Can purchased goodwill be evaluated in terms of an estimated period of existence—can it be determined to have an unlimited life or an estimated life? Unless the concept underlying current accounting practices that goodwill has an estimated period of existence is valid, any system of amortization of purchased goodwill is arbitrary and any resulting charge to income is misleading or erroneous.

The following three characteristics of goodwill bear on the question of the life span of goodwill:

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

The characteristic of goodwill that it is not consumed or used in the production of revenue recognizes that goodwill is the result of earnings, or the expectation of them; the value of goodwill is enhanced by an increase or expectation of increase in earnings. Thus, goodwill cannot properly be amortized, since amortization implies that a cost is consumed in achieving those earnings.

A charge to income for goodwill, whether purchased or nonpurchased, 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.

The position that the cost of goodwill should be amortized appears to be a vestige of "venture" accounting. Under that theory of accounting, no profit is earned until all expenditures for a particular venture are recovered. That theory, when applied to accounting for goodwill, leads to a conclusion that when a payment is made for goodwill, the payment must be deducted from income to determine the net results of the venture over a period of years. The purposes and objectives of financial accounting and reporting have gradually departed from the former close relation to venture accounting. While not all aspects of present-day accounting reflect this development, our central concern is the most useful accounting for goodwill in terms of today's purposes and objectives. Financial statements are intended to reflect the current earnings of a continuing entity, not the results of a one-purpose venture.

As stated earlier, disclosures in published financial statements of results of some individual transactions, projects, or ventures may be needed. An example in the area of business combinations is the acquisition of a business with a large short-range competitive advantage created by an unusually successful new product. The continuing

company may be planning to achieve a sizable short-range profit until that competitive advantage has expired. The earnings are disclosed most meaningfully by specific explanations and not by amortization of purchased goodwill. A similar charge for goodwill presumably expiring by the gradual loss of competitive advantage would not have been made in the accounts of the acquired business if it had not been sold. The loss of goodwill value is decided by the investor based on his opinion of the company's earning power—a decision which depends, in part, for its soundness on the adequacy of financial disclosures.

Some argue that purchased goodwill should be amortized even though its diminution is not evident. Continued existence of goodwill is considered to be the result of further efforts and expenditures and the purchased goodwill is gradually replaced by that which is newly created. Thus, amortization of purchased goodwill would be a charge to income in the same periods that expenditures "creating" new goodwill are also charged to income. Income would, therefore, be charged for expiring values at the same time that it is charged for expenditures to create new values. A quotation from a discussion of the problems of accounting for intangible assets by Walter A. Staub expresses this point:

> Further, in the opinion of the writer, it is desirable that the amortization charge be set forth as a deduction from, or appropriation of, income after the net income from operations of the period is shown. Otherwise, the income of the period is being doubly charged, once with the expenditure for the maintenance of the value of the intangibles, and again with the cost of the intangibles, the value of which is being maintained. Such a double charge against the operations of a period seems especially objectionable when the net income is being used as an indication of current earning power and consequently a factor in estimating the value of the intangibles which have been used in realizing the net income.[3]

George O. May made a similar observation:

> It is difficult to see how the assumptions [of those who would amortize goodwill] lead to the conclusion that there should be charged against revenue both a write-off in respect of the old asset and the cost of an exactly similar new asset which has taken its place.... A similar reasoning would justify the charge to operating expenses of both depreciation and the cost of replacement in respect of physical property.[4]

Some accountants have observed that expenditures to enhance or maintain goodwill value after a business combination support carrying purchased goodwill as an asset without amortization. The following reflects that view:

> ... the charging off of unlimited term intangibles, such as goodwill . . . which are being fully maintained, would result in an understatement of cost of fixed assets and an overstatement of expenses. This would be true even though it might be demonstrated in an unusual case that the original intangibles had ceased to exist and had been replaced by new values attributable to the subsequent expenditures which were charged to costs of operations. Under such circumstances, it could not fairly be claimed that the original investment should be charged off without at the same time admitting the reasonableness of capitalizing an equivalent amount of the subsequent expenditures, which would constitute a meaningless and senseless accounting procedure.[5]

To support on this basis the carrying of purchased goodwill as an asset contradicts the conclusion reached in Chapter 6 that reporting

[3] "Intangible Assets," *Contemporary Accounting*, 1945, Chapter 8, p. 5.
[4] *Financial Accounting*, 1943, p. 157.
[5] Paul Grady, "Accounting for Fixed Assets and Their Amortization," *Accounting Review*, January 1950, p. 12.

internally developed or nonpurchased goodwill in the balance sheet would be inconsistent with financial statement objectives and would serve no useful purpose. Since recording the total value of internally developed goodwill is undesirable, a portion of its value should not be used to support continuing to carry the value of purchased goodwill.

The lack of logic in amortizing goodwill to income was noted by George O. May a quarter century ago. In a discussion of the amortization of certain intangibles, he wrote ". . . it is not easy to see how inclusion of such a charge in any computation that results in a figure of net income would make that figure more generally useful or significant for any purpose."[6]

The second concept underlying present practices of accounting for purchased goodwill—that purchased goodwill can be evaluated as having unlimited life or an estimated term of existence—also appears to be invalid, since it is inconsistent with the characteristics of goodwill. Thus, this concept does not support a rational and meaningful system of amortization of purchased goodwill.

Purchased vs. Nonpurchased Goodwill

The procedures currently considered acceptable in accounting for purchased goodwill generally differ from those followed in accounting for nonpurchased goodwill. We concluded in Chapter 6 that neither the cost nor the value of nonpurchased goodwill should be recognized as an asset of a business—a conclusion which agrees generally with present accounting practices.

The characteristics of goodwill identified in Chapter 2 apply equally to purchased and nonpurchased goodwill. The only significant differences are that purchased goodwill relates to a business entity which has been acquired as a unit and the goodwill paid for in a lump sum is identifiable. Nonpurchased goodwill may also have been "paid for," in part at least, through a variety of unidentifiable transactions over the life of the business. The value of both types of goodwill is constantly changing from a variety of forces both internal and external to the business.

The question is—Does the fact that the manner of acquiring purchased goodwill differs from the manner of developing nonpurchased goodwill support a substantially different accounting treatment for the two types of goodwill? Although the form of the transactions in

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[6] *Financial Accounting*, 1943, p. 158.

which each type of goodwill is acquired or developed may differ, the substance seems to be basically the same, that is, the value of the total goodwill of the business is enhanced.

Without substantive differences in the characteristics of purchased and nonpurchased goodwill, a serious question arises as to whether two completely different bases of accounting should exist for the two classifications of goodwill—to recognize one as an asset and not the other. George O. May called attention to this inconsistency in a commentary on *ARB 48:*

> I believe further that a philosophy of accounting which treats values *created* altogether differently from exactly similar values *acquired by purchase,* is in need of revision.[7]

Proper Accounting for Purchased Goodwill

The concepts which underlie current practices of accounting for purchased goodwill—that goodwill is an asset whose value is susceptible of measurement in periods after its purchase and that goodwill can be evaluated in terms of limited or unlimited periods of existence —are not consistent with the characteristics of goodwill. As discussed in a previous section of this chapter, the practical arguments which have been advanced for capitalizing goodwill as an asset and for amortizing it are not valid.

Further, Chapter 6 of this study concluded that existing practices of accounting for nonpurchased goodwill are sound. Generally, neither the cost nor the value of developed goodwill is recognized as an asset, either to be carried forward indefinitely or to be amortized. If a business possesses goodwill, the characteristics of that goodwill are the same whether purchased or nonpurchased, and the characteristics do not provide support for the completely different approaches which now exist in accounting for the two categories of goodwill.

However, the fact that goodwill has been purchased and paid for in a business combination means that an accounting for the goodwill is necessary. Accounting for goodwill is made a more significant issue by the conclusion of *ARS 5,* a conclusion endorsed by this study, that most business combinations, whether effected by cash or stock, are purchase transactions and should be accounted for as purchases.

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[7] "Business Combinations: An Alternate View," *Journal of Accountancy,* April 1957, p. 35.

An alternative to accounting for purchased goodwill as an asset to be carried forward or to be amortized is to report the amount as a reduction of the stockholders' equity of the continuing business enterprise.

Purchased Goodwill—A Reduction of Stockholders' Equity. A portion of cash distributed to effect a business combination represents the goodwill of the acquired business and that portion is in reality a payment on behalf of the continuing stockholders in exchange for their proportionate interest in the expected excess future earnings of the absorbed company. The value inherent in the goodwill element pertains to the stockholders and represents an advance expenditure on their behalf in anticipation of future earnings.

The situation is somewhat similar in a business combination effected by issuing stock. To the extent the fair value of the shares issued in the combination exceeds the fair value of the net separable resources and property rights acquired, the combination transaction reflects a goodwill element. The goodwill element also represents consideration given on behalf of the continuing stockholders in exchange for anticipated excess earnings of the absorbed company. The fact that those receiving stock in payment for the goodwill element of their business share in the excess earnings of the continuing business when they materialize later does not alter significantly the basic transaction.

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 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 except, 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 goodwill of the absorbed company has no continuing, separate, and measurable existence after the business combination. It is merged with and, hopefully, enhances the goodwill value of the continuing business enterprise, a value which investors in turn attribute to the continuing business as a whole. Accounting for purchased goodwill as a reduction in stockholders' equity recognizes this essential characteristic of goodwill with the result that the current and prospective accounting for the entire goodwill (purchased and nonpurchased) of the continuing enterprise are consistent. Accounting for purchased goodwill in this manner and eliminating pooling of interests accounting, which this study concluded is not based on a valid concept, would result in more comparability in the financial statements of businesses which have grown by business combinations and those which have grown by internal expansion, particularly and more importantly in periods after the combination and internal expansion have occurred.

Accounting for goodwill as a reduction in stockholders' equity is superior to alternative methods of accounting for goodwill in several respects. The deficiencies of the present "nonaccounting" for goodwill which accompany the pooling of interests method are eliminated since the value of the goodwill evidenced by the business combination would be recognized and accounted for. Further, the accounting accorded the goodwill would be disclosed. Those improvements would be in addition to the better financial statements which would result from the elimination of pooling accounting and the recognition of the fair values of the separable resources and property rights acquired.

The recommended accounting for goodwill would eliminate from among the assets in a balance sheet an amount which neither represents the value of the goodwill of the business being reported on nor is useful for financial and operating interpretations about the business. The charge for amortization of goodwill which results from one alternative of accounting for goodwill would be eliminated from the income statement. Amortization can neither be reasonably related to the revenue of a period nor reasonably associated in some other manner with specific time periods.

Accounting for purchased goodwill as a reduction in the stockholders' equity of the continuing enterprise in a business combination would (a) reflect the facts of the transaction (including the fact that capital with a determinable value has been dedicated and used with the objective of obtaining future earnings) and (b) recognize the essential characteristics of goodwill in a manner consistent with the objectives of financial statements. Adoption of the recommendations of this study would require a significant change from current practices in accounting for purchased goodwill but would nevertheless be consistent with the broad conventions and concepts currently followed to meet the objectives in other areas of accounting.

Techniques for Reducing Stockholders' Equity. The reporting of purchased goodwill as a reduction of stockholders' equity can be accomplished by either of two methods: (a) by an immediate direct write-off of goodwill to a stockholders' equity account, such as capital surplus or retained earnings or (b) by showing goodwill as a separate deduction from stockholders' equity in the balance sheet. A direct write-off would avoid showing a goodwill amount in the financial statements (although amounts could be disclosed in notes), while the second method would continue to report the goodwill amount in the financial statements. Whichever method is adopted, attention must be given to disclosure and legal considerations, which may vary from one company to another. The selection of the accounting method in this case does not involve any significant question of accounting principle.

Immediate write-off—Often immediate write-off of purchased goodwill when a business combination occurs will be appropriate. If purchased goodwill is written off immediately, the amount should be deducted from capital surplus or retained earnings. However, no particular logic or reason requires that payments for purchased goodwill be deducted either from capital surplus or from retained earnings to the exclusion of the other. Accounting cannot identify a portion of cash or other property used in a purchase as coming from a particular class of surplus.

The type of surplus resulting from the issuance of stock in a business combination is identifiable. The consideration given for the absorbed company in a business combination effected by stock must ordinarily be measured by the market price of the stock that is issued. The excess of the market price of the stock issued over its par or stated value should be added to capital surplus. The goodwill acquired may be viewed as having been purchased with the proceeds of the stock issued and hence the write-off of goodwill purchased is most appropriately deducted from the capital surplus (to the extent available) created by the stock issue.

Generally, however, the board of directors of a company can decide the specific surplus account to be charged for the write-off of purchased goodwill after considering applicable state laws.

Deduction from stockholders' equity in balance sheet—As an alternative to immediate write-off, purchased goodwill may also be reported as a reduction of stockholders' equity by showing it as a separate deduction from stockholders' equity in the balance sheet. This manner of reporting has been discussed relatively little in accounting literature and apparently has relatively little precedence.

A brief consideration of accounting for treasury stock provides insight into some of the concepts involved in this alternative technique. For illustration, assume that a company has outstanding 1,000 shares of $5 par value stock which was originally issued at a premium of $2.50 a share. Also, assume that at present the book value of the stock is $10 a share which, by coincidence, is also the current fair value of its net assets, excluding goodwill. The company uses part of excess cash available to acquire 500 shares of its stock at $12.50 a share. When the shares are retired, $7.50 of the purchase price is charged to the capital stock and capital surplus accounts and the remainder is charged to retained earnings. One half of the $2,500 (500 x $5) charge to retained earnings represents a disbursement of prior earnings which had accumulated to the benefit of the stockholders whose shares are reacquired. The other half constitutes a payment for the company's own goodwill and represents, in effect, a disbursement of prior earnings of the remaining stockholders in exchange for the right to receive a greater share of future earnings.

In this example, the company purchased a portion of its own stock at a price which included a payment for at least part of the company's own goodwill, that is, the excess of purchase price over book value of the interest in net assets. The appropriateness of the described accounting treatment is generally not questioned. No useful purpose would be served by recording the cost of the purchased goodwill as an asset. Likewise, no purpose would be served by amortizing the cost to future income. The cost of the goodwill element is reported as a cost of treasury stock (a reduction of stockholders' equity) until the shares are canceled. When the shares are retired the goodwill purchased is deducted from retained earnings.

This example, although not a perfect analogy for typical purchased goodwill, illustrates a reduction of stockholders' equity by an expenditure for goodwill.

J. E. Sands suggested that the cost of purchased goodwill should be shown as a deduction from stockholders' equity. He viewed purchased goodwill as an "expenditure for competitive advantage," and stated:

> "Accumulated unamortized expenditures for competitive advantage" should be shown in the statement of financial position as a deduction from earned surplus, or if surplus alone is not sufficient, from common share capital and surplus together. . . . If there is not sufficient common shareholders' equity for this purpose, the accumulated unamortized expenditures should be shown as a deduction from the common plus preferred shareholders' equity and if this is not sufficient, from the creditors' equities as well. In short, accumulated unamortized expenditures for intangibles should be deducted from as many forms of equity as are necessary to cover them, in the order in which those equities are available to meet losses of entity wealth.[8]

The advantage of carrying the cost of purchased goodwill as a separate deduction from total stockholders' equity is that it shows on a continuing basis the amount of equity dedicated to this purpose. The following comment by Sanders, Hatfield, and Moore reflects that view:

> When actual consideration has been paid for goodwill, it should appear on the company's balance-sheet long enough to create a record of that fact in the history of the company as presented in the series of its annual reports. After that, nobody seems to regret its disappearance when accomplished by methods which fully disclose the circumstances.[9]

Freeman H. Davis later commented on the above quotation:

> If a company has followed the policy of writing off its intangibles, it would seem that a charge to surplus for goodwill acquired during the current year would be a sufficient record of the fact of acquisition and the subsequent write-off of goodwill. In other words if a corporation, having previously written off all goodwill, acquires additional goodwill, it should not be compelled to carry it as an asset until the subsequent year before writing off, since the published surplus statement would give as much information in respect to the recently acquired goodwill as would the balance sheet.[10]

Continuing to disclose purchased goodwill by the alternative technique of showing goodwill as a deduction from total stockholders'

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[8] *Wealth, Income, and Intangibles*, 1963, p. 84.
[9] *A Statement of Accounting Principles*, 1938, p. 14.
[10] "Goodwill and the Balance Sheet," *New York Certified Public Accountant*, October 1940, p. 36.

equity is unlikely to be helpful or meaningful in many cases. Information on recovery and profitability of a particular investment which is significant to the investor is best conveyed by special analyses supplementing the conventional financial statements. However, the deduction presentation may be necessary if the total of the surplus accounts of the continuing enterprise were less than the cost of purchased goodwill.

The question has been asked, what would be the situation if purchased goodwill exceeds the entire amount of capital stock and surplus? That would seldom happen, but could occur in certain business acquisitions for cash. In that event, the facts are that an amount of capital in excess of total stock and surplus has been dedicated to obtaining future earnings, and the stockholders have no equity in the separable resources and property rights of the combined business.

9

Accounting Treatments in Related Areas

The conclusions reached in this study on the broad problem of accounting for purchased goodwill and business combinations affect a number of accounting treatments. Related areas are:

—Absorbed company retained as subsidiary of continuing enterprise.

—Value of acquired assets exceeds consideration given ("negative goodwill").

—Accounting for business combinations in which no constituent entity is clearly the continuing enterprise.

—Combined historical financial statements.

—Subsequent sale of all or part of acquired company.

—Mergers involving related parties.

Absorbed Company Retained as Subsidiary of Continuing Enterprise

Consolidated Financial Statements. The absorbed company in many business combinations is retained as a subsidiary of the continuing enterprise or of another company included in a consolidated group. The financial position and results of operations of the continuing enterprise and subsidiaries, including the absorbed company, are presented in consolidated financial statements as though they were a single company. Consolidated financial statements recognize the essentially single business entity, even though various operations are carried on in subsidiaries.

The form of the combination should not change its substance. The element of goodwill is still present in the investment in an absorbed company which continues as a subsidiary and should be accounted for in a manner consistent with that which would be employed if the subsidiary were merged into the parent company at the time of the acquisition.

The portion of the investment in the stock of the subsidiary equal to the fair value of the separable resources and property rights of the subsidiary at the date of acquisition should be allocated in consolidated statements to those resources and property rights. Any remaining portion of the investment should be allocated to purchased goodwill. The conclusions expressed in the preceding chapter apply to accounting for all purchased goodwill, whether the absorbed company is merged with the acquiring company or is retained as a subsidiary of the acquiring company.

Separate Financial Statements. Consolidated financial statements are prepared on the basis that the parent company and subsidiaries are one entity. However, questions arise as to the appropriate accounting and presentation in separate financial statements for the parent company and for the subsidiaries. The disposition in the statements of the parent company of the goodwill portion of an investment in a subsidiary is of particular significance to this study.

The conclusion of this study that purchased goodwill should be accounted for as a reduction in stockholders' equity relates to the presentation of financial position and earnings of the single, continuing business enterprise that results from a business combination. Technically, parent company statements, insofar as they concern the investment in a subsidiary, may be said to represent statements of an investor. As discussed in Chapter 2, goodwill is a value determined by the investor and is a value which runs directly to the investor, rather than an asset of the business enterprise itself. Thus, the goodwill portion of an investment is appropriately carried as an asset in the balance sheet of the investor. This analysis suggests that purchased goodwill should be retained as a part of the investment in the separate financial statements of the parent company, even though it is accounted for as a reduction in stockholders' equity in consolidated financial statements.

Consolidated financial statements are generally viewed as the primary statements and as the best presentation of financial position and results of operations of a total entity. Paragraph 1 of *ARB 51* states: "There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies."

Accountants generally view separate financial statements of a parent company more broadly than representing those of an investor and attempt to some degree to harmonize separate statements with the consolidated statements. An example of harmonizing the statements is the trend toward accounting for investments in subsidiaries on the equity basis, whereby a parent company records in its accounts its share of the undistributed earnings and losses of unconsolidated subsidiaries since acquisition. Thus, the net income and stockholders' equity of the parent company are the same as on a consolidated basis. Accountants generally regard the equity basis, which achieves results consistent with consolidated statements, as useful.

If parent company statements are issued to supplement the consolidated statements, purchased goodwill should also be accounted for as recommended for consolidated financial statements—as a reduction in stockholders' equity. Parent company statements may occasionally be issued as the basic financial statements (no consolidated statements issued), with the parent company viewing its cost of an investment in a subsidiary strictly as an investment. If so, no business combination, in effect, has occurred. The recommendations relating to purchased goodwill discussed in this study would, therefore, not apply and the investment in the subsidiary would be accounted for the same as other investments.

Presenting separate financial statements of a subsidiary creates some questions. The discussion of financial statement objectives in Chapter 3 stated that financial statements are ordinarily most useful when they reflect separable resources and property rights at fair values objectively determined. Thus, if separate financial statements are to be issued for a subsidiary, the values determined in the business combination, excluding goodwill, should preferably be recorded in the accounts of the subsidiary. For the subsidiary the business combination is often the equivalent of a "fresh start," thereby providing support for new carrying amounts under existing concepts of accounting. The existence of minority interests and other circumstances, however, may make it impractical to record new amounts in the accounts of the subsidiary.

Value of Acquired Assets Exceeds Consideration Given ("Negative Goodwill")

The goodwill value in a business is a value over and above the total value of the net separable resources and property rights of that business. Goodwill results from the expectation of earnings from those resources and property rights. The resources and property rights of a business can be separated from the goodwill which attaches to a business, but goodwill has no value outside the related business operations. Goodwill may enhance the value of a business as a whole, but the absence of goodwill does not diminish the value of the separable assets of a business.

The values attributable to the separable resources and property rights may exceed the value of a business as a whole. In some business combinations, the consideration given is presumably less than the fair value of the net resources and property rights acquired; the difference is often referred to as "negative goodwill." Those situations may arise when a company fails to produce sufficient earnings to sustain a value on the business as a whole equal to the value of its separable resources and property rights or when investors are pessimistic about a company's prospects for earnings. However, demonstrating that the net value of the separable assets of a business is greater than the consideration given for the entire business is ordinarily difficult. If the assets have a greater value apart from their existing operating functions, the source of greater values must be presumed to have been available to the seller. Prudence would dictate that the seller seek the most advantageous disposal. Presumably, the seller could elect to liquidate and sell individual assets if indeed the value of the business as a whole is less than the total value of individual assets. Thus, when "negative goodwill" appears to exist, careful evaluation of the assets is needed, since the amount may be allocable to the separable resources and property rights (or liabilities) in determining the value of the elements of a business acquired.

For various reasons, including the inconvenience and delay of disposing of assets separately, the current value of the net separable resources and property rights may in fact exceed the value of the business as a whole. When special expenditures are necessary to improve organization, management, and controls, or for advertising and research to overcome the deficiencies in the operations of the acquired business, the "negative goodwill" should be set aside as a liability for those costs, and the special expenditures should be charged against the liability as incurred. However, a liability should not be recorded in the absence of specific plans for related expenditures; otherwise future income would be relieved of normal expenses.

When the "negative goodwill" is not allocable to individual assets or liabilities and cannot be associated with identified and related costs to be incurred, the amount should be added directly to stockholders' equity at the time of acquisition. Absent any significant legal or other considerations, the amount may be credited appropriately either to retained earnings or to capital surplus as determined by the board of directors.

Accounting for Business Combinations in Which No Constituent Entity Is Clearly the Continuing Enterprise

In those relatively few business combinations in which one constituent entity is not clearly the continuing enterprise, the transaction results, in effect, in the creation of a new business. Thus, accounting for those combinations should be similar to accounting for the creation of new businesses.

Basis of Accounting for New Business Enterprise. The resources and property rights received in the creation of a new business are generally recorded at their fair value at the date received. The amounts recorded in the accounts of the predecessors of a new business enterprise created by a business combination are ordinarily not relevant to the new enterprise nor are they a proper basis for establishing new accountability. In this connection, George O. May, who took issue with the conclusions of *ARB 48*, said:

> The first objective of any rules applicable in these cases should be to insure the creation of adequate information on which to base charges against revenue in the future. It is now generally recognized that the main importance of monetary ascriptions given to wasting capital assets arises from the fact that they will form the basis of charges against revenues in the future. One corollary that follows is that these monetary ascriptions will be the more significant and useful the more closely they reflect the effective cost to present-day stockholders of their interest in the surviving corporation, rather than the effective cost to stockholders of a prior gen-

> eration. There is always a presumption in favor of a more recent measure of accountability as against an earlier one and the presumption becomes stronger the older the historical basis is.[1]

Wyatt developed in Chapter 7 of *ARS 5* what he termed "the fair value pooling concept" which would be applicable to those business combinations in which the resultant enterprise is, in essence, a new enterprise. Under this concept, the assets of the resultant enterprise would be accounted for at their fair value as of the date of the combination; since the enterprise is a new business entity, no retained earnings would be carried forward and the retained earnings legally available for dividends would be disclosed. We generally concur in the conclusions reached by Wyatt and believe that this concept is appropriate, with certain modifications or clarifications, for all business combinations in which one entity is not clearly the continuing enterprise.

Goodwill in New Business Enterprise. The fair value of the respective constituents as a whole, including the value of goodwill, is normally determined by negotiations coincident to the exchange transaction, based on all available data. The fair value of the businesses as a whole generally determines the exchange ratios finally negotiated. The fair values contributed by each constituent therefore serve as a basis for determining the stockholders' equity in the new enterprise. The stockholders of each constituent contribute their values in exchange for an interest in the values of a new enterprise, and each shares in the benefits of goodwill developed by the other.

The value of the goodwill of each constituent is important in determining the terms of the exchange transaction, but the values have no accounting significance after the combination is accomplished. The goodwill of the resulting combined enterprise may possibly exceed the sum of the values of goodwill of the separate entities. The fair values to be recorded for the new enterprise should exclude the value of goodwill contributed, whether that goodwill was developed by the constituents or had been previously purchased. Thus, the amount of stockholders' equity in the new enterprise represents the sum of their joint contributions of separable resources and property rights to be used or consumed in subsequent operations.

[1] "Business Combinations: An Alternate View," *Journal of Accountancy*, April 1957, p. 35.

The accounting treatment recommended for the goodwill associated with business combinations which result in a new enterprise is consistent with previous conclusions in this study that neither purchased nor nonpurchased goodwill should be recognized as an asset. It is also consistent with the accounting procedure for new businesses created by other than a business combination; goodwill values which arise or exist in newly organized businesses have ordinarily not been recorded as assets.

Retained Earnings in New Business Enterprise. Under the "new business" concept, the resultant entity would not carry forward retained earnings of the constituents. The new enterprise would report as retained earnings only undistributed profits subsequent to the creation of the enterprise.

Wyatt recognized that carrying forward the retained earnings of the constituents may have "practical application in some circumstances."

> . . . in many situations valid reasons may exist for carrying forward the amount of earned surplus legally available for dividends. . . . In any event, if the earned surplus carried forward differs materially from the amount of surplus available for dividends, this latter amount may be disclosed parenthetically. Subsequent earnings of the resultant enterprise would not necessitate separate disclosure.[2]

Disclosing undistributed past earnings of constituents of a combination which is, in effect, the creation of a new business enterprise may be advisable in some circumstances. However, undistributed past earnings should not be reported as retained earnings of the new enterprise.

Combined Historical Financial Statements

The presentation of statements of income, and of some balance sheets, for prior and current periods on a combined basis, with pro forma adjustments for changes in depreciation, interest, and other items resulting from the business combination, may be useful to the

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[2] *Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations," 1963, p. 85.

investor in appraising trends and the earning power of the continuing entity. Such statements should be encouraged as supplemental information but must be clearly distinguished from the pooling of interests concept which regards the combined statements of the constituents as the basic statements of the continuing enterprise. Under purchase accounting, recommended by this study for most business combinations, the statement of income of the continuing entity should include the results of operations of the absorbed company only from the date of combination.

The presentation of combined historical financial statements of the constituent companies on a pro forma basis may also provide useful information when a business combination has resulted in the creation, in effect, of a new business enterprise.

Subsequent Sale of All or Part of Acquired Company

This study has been concerned primarily with business combinations in which the acquired company is to be operated as a part of the continuing enterprise. When a company is acquired (with a payment for goodwill involved) and is subsequently sold, either in whole or in part, a question arises as to the accounting for the proceeds. If the entire acquired company is sold, any profit on the sale up to the amount of the original goodwill should be credited to the account to which the goodwill was initially charged. Similarly, if a segment of the acquired company to which a portion of the original goodwill was related is sold, any profit up to the amount of the related goodwill should be credited to the account to which the goodwill was charged. In either case, the balance of the profit, if any, should be reflected in the income statement for the period of sale. Appropriate consideration should be given to income tax allocation.

When a sale of part of an acquired company occurs within a relatively short period following the business combination, care must be exercised in determining a profit or loss. The sale may provide a more objective and realistic basis for allocating the purchase price than the basis used when originally allocated; thus, it may be appropriate to adjust the original allocation before accounting for the proceeds of sale.

Mergers Involving Related Parties

The discussion of business combinations in this study has contemplated arm's-length transactions between independent parties. When (a) a wholly owned subsidiary is merged into its parent company, (b) two wholly owned subsidiaries are merged with each other, or (c) a merger of commonly held enterprises occurs, no independent exchange of ownership interests is ordinarily involved. The amounts of assets and liabilities previously recorded in the accounts, as well as the amount of retained earnings, should ordinarily be carried through the merger and recorded in the accounts of the combined entity. Also, prior year statements of income should be reported on a combined basis.

10

Summary

Principal Recommendations

The principal recommendations of this study with respect to (a) accounting for goodwill and (b) the related broader problem of accounting for business combinations are:

1. Most business combinations, whether effected by payment in cash or other property or by the issuance of stock, are purchase transactions and should be accounted for the same as other purchases. Wyatt reached the same conclusion in *Accounting Research Study No. 5.*

2. The total value of the consideration given in a business combination should be accounted for in recording a purchase transaction. The value of the consideration is the amount of cash paid, the value of other assets or notes given, and/or the fair value of the stock distributed.

3. The separable resources and property rights acquired in a business combination should be recorded at fair value at the date of the purchase. The difference between the value of the consideration given and the fair value of the net separable resources and property rights acquired should be assigned to purchased goodwill.

4. The amount assigned to purchased goodwill represents a disbursement of existing resources, or of proceeds of stock issued to effect the business combination, in anticipation of future earnings. The expenditure should be accounted for as a reduction of stockholders' equity. The accounting can be achieved by one of two methods: (a) an immediate direct write-off to capital surplus or retained earnings (the preferred method) or (b) showing a deduction from stockholders' equity in the balance sheet for several periods and a later write-off to capital surplus or retained earnings. The selection of method may involve significant legal and disclosure matters to be resolved by the board of directors but is not a question of accounting principle.

   The recommended treatment of purchased goodwill results in balance sheet and income statement reporting for purchased goodwill which is consistent in principle with existing practices of accounting for internally developed or nonpurchased goodwill—practices which this study considers proper.

5. The conclusion that most business combinations are purchase transactions has the corollary conclusion that pooling of interests accounting is not valid. Hence, various related procedures which are based on the pooling of interests concept, such as carrying forward the retained earnings of the absorbed company to the retained earnings of the continuing entity, are not proper.

6. The relatively rare business combination in which no constituent clearly emerges as the continuing entity results, in effect, in the creation of a new business enterprise. The accounting should be that generally accorded the formation of new enterprises—that is, the separable resources and property rights should be recorded at fair value and no amounts should be recorded for goodwill.

Conclusions Supporting Recommendations

A summary of the principal conclusions supporting the recommendations of this study follows.

Nature and Valuation of Goodwill

1. The investor determines the value of a business enterprise, based on his appraisal of the earning power of a company. His appraisal is based in part on the information which financial statements provide as to the past performance of the business. The investor-determined value of a publicly held company is evidenced by the market price of the company's stock.

2. Investor opinion of values is influenced by innumerable factors including the investors' collective evaluation of and prejudices and reactions to political, economic, or social events; investor opinion is subject to the same types of factors and forces which mold public opinion generally. The role of accounting is to provide information which the investor can use in arriving at his opinion of the value of a business; accounting does not determine that value.

3. The difference between the value of an entire business and the value of its net separable resources and property rights committed to the production of earnings is called goodwill. Goodwill reflects the evaluation of the earning power of the business by investors and is generally not accounted for except when a business is a party to a business combination and is acquired by another.

4. Goodwill is not a resource or property right that is consumed or utilized in the production of earnings. Rather, it is a result of earnings, or of the expectations of them, as appraised by investors. Goodwill exists only as a part of the value of a business as a whole and has no existence or life separate from the business.

5. Goodwill value represents the aggregate opinion of investors and is subject to sudden and wide fluctuations. That value has no reliable or continuing relation to costs incurred in its creation, its purchase, or its maintenance.

These and other distinguishing characteristics of goodwill indicate that goodwill clearly differs from other elements of the value of a business.

Financial Statement Objectives

1. Financial statements provide information about business enterprises. The information is significant only if it is useful and meaningful to investors and other users of the financial statements. The principal test of the soundness of accounting principles and practices, therefore, lies in the usefulness of the resulting information.

2. The decisions of investors involve the process of choosing the securities of one business over those of others. Financial information is most useful for investor decisions if it is prepared on a comparable basis among businesses, so that the differences in the reported financial position and profitability of one company as compared with others represent differences in conditions and circumstances and not merely differences in accounting practices.

3. The quality of a business is judged principally by its success in achieving earnings, and earnings as reported in the statement of income are among the most important facts which financial statements provide about a business. The "earning power" of a business is also becoming increasingly significant. The record of past earnings is a significant factor in the investors' appraisal of a business enterprise's prospects for future earnings—an appraisal which, regardless of the myriad factors which influence investor opinion, primarily governs the market price of the enterprise's stock and the value of the business as a whole.

4. Information about the value of the separable resources and property rights committed to the production of earnings in a business is also of interest to investors and creditors. The balance sheet provides this information, subject to the limitations of the cost basis.

5. Accounting employs certain conventions to fulfill the financial statement objectives of providing information about the earnings and the value of the resources and property rights of a business. The conventions provide a practical framework to assure reasonable standards of objectivity and consistency in the information reported. Foremost among these conventions are the realization principle in recognizing revenue and, its corollary, the cost

basis of carrying assets in the balance sheet. These conventions are necessary in accounting, even though they may restrict the usefulness of financial statements. For example, the cost basis is useful, but the balance sheet is more useful the closer the amounts ascribed to individual resources and property rights are to their current values determined objectively. Solutions to individual accounting problems must be sought with those conventions and effects in mind.

6. The realization principle for recognizing revenue gives rise to the central problem of accounting—the "matching" problem. Which expenditures should be deferred and matched against the benefits to future income resulting from the expenditures and which expenditures should be recognized as charges to income when incurred? A number of discernible conventions or accounting rules have evolved for matching. Only those expenditures attributable to specific resources or property rights which have values in and of themselves, apart from the business as a whole, have ordinarily been reported as assets. Thus, existing practices of accounting for purchased goodwill are inconsistent with accounting practices in other areas.

Effect of the Form of Business Combinations

1. Business acquisitions and combinations may be effected by stock or cash, but this is only a difference of substitute forms of consideration and is not a substantive difference. No logical basis exists for the two radically different approaches to accounting for business combinations: pooling of interests and purchase accounting.
2. One entity continues in most business combinations and it, in effect, buys the business and assets of the other entity or entities, regardless of (a) whether the purchase is effected by payment in cash or other property or by the issuance of stock, or (b) which company is merged into the other or which company becomes the parent. Thus, most business combinations are purchase transactions.
3. The amount paid for a business, including its goodwill, in a combination effected by issuing publicly traded stock must be related to the market price of the stock issued

(with appropriate adjustments for fluctuations incident to the combination). The market price is the best representation of the consideration given, and the amount by which the market value exceeds par or stated value should be credited to capital surplus.

4. In a few business combinations, none of the constituents clearly emerges as a continuing entity. In effect, the business combination results in a new business enterprise.

Accounting Considerations

1. Except in a few business combinations in which the combination is not a purchase transaction but creates a new enterprise, the proper accounting for business combinations is found in the general concepts underlying purchase accounting. Pooling of interests accounting is not a valid method of accounting for business combinations.

2. The recognition, under existing practices of purchase accounting for business combinations, of the fair value of the separable resources and property rights of the acquired company in the accounts of the continuing company is appropriate and consistent with the cost basis of accounting. The fair values are more significant in the balance sheet and as bases for charges to income than the older, historical costs in the books of the acquired company. The carrying amounts of the acquired company are unrelated to the accounts of the continuing company, except for their tax effects where they are carried forward for income tax purposes.

3. The difference between the value of the consideration given (cash, other property, or stock) and the fair value of the net separable resources and property rights acquired represents the amount paid for goodwill and should be so allocated.

4. Current practices of accounting for goodwill purchased in a business combination and for nonpurchased (internally developed) goodwill are completely different. The difference in accounting is not supported by differences in the nature of the two types of goodwill, since

the characteristics which distinguish goodwill from other assets apply to purchased goodwill as well as to nonpurchased goodwill.

5. Under existing practices of accounting, ordinarily neither the *cost* nor the *value* of nonpurchased goodwill is reported in the balance sheet to be amortized to future income. Current practices are appropriate and should not be changed because:

   Expenditures which create goodwill cannot be identified with the particular values which they may create, and any capitalization-amortization of costs would be based on arbitrary or hypothetical assumptions and therefore could not form the basis for a meaningful measure of assets or of charges to income.

   Recognition of the value of nonpurchased goodwill in the financial statements would suggest the 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 the financial statements which are designed to furnish information which investors use in arriving at their opinions.

6. Purchased goodwill—the goodwill value of an absorbed company at the date of a business combination—has no continuing, separate measurable existence after the combination and becomes merged with the total goodwill value of the continuing business entity. Thus, the existing capitalization-amortization procedures of accounting for purchased goodwill are not appropriate since the underlying concepts—that purchased goodwill may be measured in subsequent periods in terms of value and periods of existence—are not valid.

7. Purchased goodwill, as a value created by earnings or by expectations of them, does not belong as an asset in a balance sheet whose objective is to show the separable resources and property rights used in the production of

earnings. That procedure introduces investor opinion as to the value at one point of one segment of the business of the combined company—a value which can have no continuing significance to investors and creditors who use the balance sheet.

8. The amortization of purchased goodwill in the determination of earnings does not represent the cost of a resource consumed to produce those earnings. Goodwill is a result of earnings or of the expectations of them; amortization of goodwill has an improper circular effect because the amortization may affect the values those earnings are designed to measure.

9. Amounts paid for goodwill in a business combination represent expenditures of a company's resources (a portion of the value of the stock issued in a combination effected by stock) for the opportunity to gain additional resources (earnings) in the future. The resources expended can be restored and additional ones added only if earnings are realized later.

10. Thus, amounts paid for purchased goodwill in a business combination represent reductions in stockholders' equity and should be accounted for accordingly. Accounting for purchased goodwill in this manner is also consistent with the accounting for the goodwill value of the continuing entity with which the purchased goodwill has in fact been merged.

11. Careful appraisal and allocation of the purchase prices should disclose few combinations in which the value of the net resources and property rights acquired exceed the value of the consideration given. "Negative goodwill" may arise occasionally, however, because sellers may encounter difficulties and delay in alternate dispositions of the assets of the absorbed company. In those rare combinations, "negative goodwill" should be recorded as a liability for special expenditures which may be needed to improve profitability; if no special expenditures are contemplated, the amount should be added to capital surplus or retained earnings as determined by the board of directors after considering applicable legal requirements.

Legal and Income Tax Considerations

1. Business combinations must be carried out in accordance with the applicable state laws. Some business combinations are statutory mergers under certain state laws. The practices recommended in this study are not intended to violate any laws, since the effect of the recommendations is more restrictive than most laws. Statutory mergers, however, may require disclosures of significant information; for example, the amount of surplus available for dividends.
2. Some business combinations represent tax-free exchanges of stock, and no "step up" of the tax basis of the assets acquired is permitted. Tax-free exchanges do not prohibit the type of purchase accounting recommended in this study. The income tax treatment of the business combination must be considered in allocating the consideration paid to separable resources and property rights and to goodwill but does not affect determination of the value of the consideration given.

Recommended Procedures and Objectives of Financial Statements

This study concludes that all business combinations, whether effected by stock or by cash, are purchase transactions, except those relatively few combinations in which one constituent does not clearly emerge as the continuing entity and the newly created business enterprise is accounted for as such. This study recommends that the pooling of interests method be eliminated as acceptable accounting for business combinations.

Existing purchase accounting related to purchased goodwill, however, should be revised. For the reasons summarized in this chapter, this study recommends that amounts paid for goodwill in a business combination be accounted for as a reduction of stockholders' equity at the time of the combination.

The authors of this study believe that the recommended procedures satisfy the general criteria or guides established in the discussion of the objectives of financial statements in Chapter 3. The criterion of usefulness is discussed last, since the usefulness must be tested in the light of the other criteria.

Comparability. Elimination of pooling of interests accounting results in comparability in accounting for business combinations, a comparability that does not now exist under the two radically different accounting approaches considered to be optional for a large portion of today's business combinations.

Purchase accounting for business combinations, requiring an accounting for the fair value of the separable resources and property rights acquired, is comparable to the present accounting for the acquisition of such assets in other ways. Further, comparability in the future is achieved between the financial statements of businesses which have grown by business combinations and those which have grown by internal expansion, by deducting from stockholders' equity at the time of the combination the amounts paid for purchased goodwill.

Financial Statements Serve the Future. Earnings reported under the recommended procedure of accounting for purchased goodwill are a more useful guide in appraising earning power. The assignment of current values to separable resources and property rights acquired in a business combination produces more realistic charges for depreciation and other expenses than result from pooling of interests accounting which embodies the older historical costs of a predecessor company. Also, the recommended procedure eliminates charges to earnings for values not used or consumed in the production of earnings but which result from earnings or from expectations of them.

Current Values of Resources (Assets)—Important Information. Purchase accounting is clearly better than pooling of interests accounting in ascribing more current values to the resources of a business. A result of the cost basis is that purchase accounting adjusts to current values the assets of the absorbed company only. We noted in Chapter 3 that the cost basis places some limitations on the usefulness of the balance sheet in serving its objectives of disclosing information about the value of the resources and property rights of a business. However, this is a general limitation of the cost basis, and "mixed" costs or values exist in the financial statements of any business whose assets have been acquired at different dates under a variety of circumstances and is not a problem peculiar to business combinations.

Enterprise Value Determined by Investor—Not an Accounting Function. In recording purchased goodwill as an asset and in charging earnings for its amortization, present accounting practices for purchases introduce investor opinion of the value of a business into the information which accounting supplies the investor as a basis for that opinion. The procedures recommended by this study for accounting for purchased goodwill do not create the confusing results of this circular effect which impairs the usefulness of financial information.

Observance of Present Basic Accounting Conventions. Purchase accounting is consistent with the cost basis of valuing resources and property rights. Accounting for purchased goodwill as a reduction of stockholders' equity is consistent with the general rules adopted in accounting for deferring as assets only those costs which have reasonably clear periods of income benefit *and* which are directly associated with specific separable resources and property rights. Separable resources and property rights have values in themselves apart from the value of the business as a whole, which is not true for goodwill.

Usefulness. The principal conclusions of this study satisfy the criteria established in our discussion of financial statement objectives in Chapter 3 for judging the soundness of accounting practices for goodwill and business combinations. These conclusions lead to improvements in financial reporting by (a) recognizing the fair values of the separable resources and property rights acquired in business combination transactions, (b) providing for measurement and disclosure of any goodwill value acquired in a business combination, and (c) reporting as assets only those separable resources and property rights which have future value to the business and as revenue charges only those costs incurred which are identifiable with the revenue of the period or are assignable to a period on some other reasonable basis. Thus, adoption of the conclusions would make financial statements more useful in accounting for business combinations in a manner responsive to the objectives of financial statements.

Comments by Members of Project Advisory Committee

Comments of Charles F. Axelson

The accounting research study on "Accounting for Goodwill" has been a good attempt to reduce the problem to writing. Although already far too long, it still omits complete coverage of (1) all of the theoretical arguments for and against and (2) the definitions, standards, and suppositions that have been used. Considering the time that has already been spent on this study one must conclude, therefore, that the subject is too complex to be solved by a theoretical-logical-analytical approach and must be solved on practical grounds.

I am in complete agreement with the conclusions reached in the study that purchased goodwill should not be booked as an asset to be amortized over some future period. Whether it should be first booked on a stock purchase (and then immediately deducted from equity) or whether it should not even be booked in the first place (as under pooling of interests accounting) is perhaps open to further discussion.

We must not lose sight of the fact that in attempting to resolve the dilemma surrounding the accounting for purchased goodwill, we are talking about accounting principles applicable to financial statements used by *outsiders*—investors, would-be investors, credit grantors and bankers. Although I am not an authority on what outsiders are doing, I am under the distinct impression that most sophisticated outside analysts of financial statements are disregarding purchased goodwill when it appears in financial statements and thus, in effect, writing it off against equity.

The accounting principles promulgated by the AICPA must be realistic and in keeping with modern developments. They cannot be promulgated by theorists who are out of touch with the way in which users of financial statements are interpreting them. Furthermore, written material should be short, concise and to the point or it is not going to be read by the recipients. The final pronouncement or ruling of the Accounting Principles Board should cover no more than two pages.

Considering the many ramifications in accounting for purchased goodwill, and the difficulties to date in trying to resolve this problem, I believe that the AICPA should not attempt to resolve it alone. This subject needs the support of an advisory council (such as formed on *Financial Reporting By Diversified Companies*) made up of representatives of the Financial Executives Institute, The Institute of Internal Auditors, National Association of Accountants, American Accounting Association, The Financial Analysts Federation and other interested parties.

Comments of Donald J. Bevis

The research study on "Accounting for Goodwill" fills part of the void in our literature on the subject. Therefore I agree with its publication.

In my opinion, however, the study arrives at an arbitrary and illogical solution that is not based on the economic aspects of most business combinations. Too much emphasis is given to the relative market prices of securities involved in acquisitions and not enough attention is paid to the fundamental values and reasons underlying the transactions. Further, the study is incomplete in its discussion of the pooling concept and new enterprise accounting.

I am not convinced that goodwill should be imputed and immediately written off in the "true" marriage or pooling. The pooling concept has been subject to abuse, but there are situations, particularly where the combining companies are relatively comparable in size, in which it would appear that the pooling concept is appropriate.

Greater attention should also have been given to "new enterprise" accounting. The study does not adequately deal with the situations in which that accounting would be proper. Criteria distinguishing between true marriages and new enterprises have not been developed.

Finally, if the combination does involve the purchase of goodwill, then the cost of that asset should be accounted for in a manner similar to that followed for other acquired assets. Goodwill seldom if ever has a perpetual life; admittedly in some cases its life is difficult to determine. This does not change, however, the basic concept that its cost should be related to future revenues or future time periods.

Comments of Philip L. Defliese

The best that can be said for this study is that it is a pragmatic approach to "Non-accounting for Goodwill." The accounting enigma of goodwill cannot be summarily disposed of by writing it off just when it is acquired, in view of the fact that it represents a cost incurred in good faith by competent men. Admittedly, such a course has appeal if for no other reason than that it gets rid of a troublesome item. But an answer to an accounting question must have more than appeal. Unless backed by cogent, persuasive reasoning, the answer avoids the problem rather than solving it. Frankly, I find the study deficient in supplying adequate reasoning to support its conclusions. Resurrecting the spirit of the late '20's and early '30's, when in the interest of conservatism, it was popular to write off anything that might embarrass future reported results, just won't do.

Goodwill, as the study observes, is of rather an elusive nature. Everybody readily recognizes its presence but there is no agreement on a precise definition of it, or about how it originates, or of the conditions evidencing its continuing existence. The study goes a long way in this attempt, but it falls short in many respects. Here are some of the points which were either omitted or never fully developed:

I—Before the pooling concept can be completely abandoned, as the study proposes, it should be recognized that all poolings fall broadly into either of two types:

Type A—The managements of two companies, of relatively comparable size, whose voting securities are widely held and actively traded, decide upon a business combination (usually a tax-free exchange) to be accomplished by exchanging their securities using a ratio that is based largely upon relative market quotations. Exchange ratios in these cases usually have little or no dependence upon underlying tangible and intangible asset values; relative market values of the shares (usually reflecting judgments as to potential earning power) predominate the determination. Because current market quotations are strongly influenced by reported earnings of the past, recognition is sometimes given, in setting exchange ratios, to the differing accounting principles in use by the parties and the potential effect upon earnings of the need to conform them.

Type B—A large publicly-held company acquires a smaller, closely-held company (or one whose voting securities are not actively traded) by an exchange of securities which is determined by first setting an overall price and then dividing it by the current (or expected) market quotation of the stock offered. Asset valuations, earnings, tax considerations, effect of the transaction upon future reported accounting results, market conditions, etc., all enter into the process of determining the price to be paid in terms of shares; however, a combination of cash and securities is also frequently seen.

These examples are an oversimplification, of course. No two business combinations are alike and variations with features of each of these two types will always be found. But, as with most accounting problems, once the underlying facts are established and evaluated the accounting becomes clear. Disregarding the fact that in all marriages one partner generally becomes dominant (and economic disparities are not always the cause), it seems that the Type A transaction is a pooling as that concept was first envisioned and I see no reason to abandon it without further study. The Type B transaction strongly suggests an acquisition or purchase, and should be dealt with accordingly. This study's endorsement of the prior study by Arthur Wyatt (*Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations") without any apparent further consideration detracts from its usefulness.

II—Present accounting theory and practice are based upon the concept of historical cost accountability. If the continued utility of this concept is accepted (and the authors of the study have not disputed this point) and goodwill is a valuable asset, then the study cannot proceed to dispose of it for the reasons given. The many faceted nature of goodwill as we find it today must be carefully studied in order to determine its accounting. Generalizations such as the "tendency of customers to continue" or the purchase of earnings in excess of a return on tangible assets cannot be postulated. The kind of goodwill acquired in a particular transaction must be analyzed and evaluated—for example, can the excess be attributed to the same characteristics for all of the following types of companies:

a. one-product company engaged in the manufacture of a gadget presently popular with teen-agers,

b. a popular soft-drink bottler with a (no-cost) perpetual franchise and established routes,

c. a research organization with a record of successful development of scientific products and discoveries,

d. a multi-product company engaged in manufacture and distribution of brand-name edibles,

e. a successful retail chain store operation,

or do not the differences in activities suggest the need for different approaches in dealing with the "excess"? Careful analysis will probably show that goodwill arising in different transactions possesses different attributes calling for different accounting. I believe that the varying aspects of goodwill have been recognized in a general way but doubt that they have been given adequate consideration in our accounting.

There is a further pertinent point. Do the differing aspects of goodwill suggest that in some cases self-developed goodwill arises the same as purchased goodwill—that is, from expenditures that may be written off as incurred or after? A careful analysis will show that goodwill may be the result of spending a lot of money, or spending none, or of being at the right place at the right time, or of cornering brains, or stumbling on a product, etc. Consequently, generalized analogies cannot be drawn. Each element must be dealt with separately; once analyzed, the accounting should become clear. Costs are amortized because they have a limited life, not for conservatism. (Do we depreciate land or amortize permanent franchises?) If the value suddenly disappears (as in the case of unsuccessful deferred development costs) it is written off against earnings when this fact becomes apparent. Many of those who argue for amortization of goodwill take the position that it represents the purchase of excess earnings for x years and should be written off over that period. If this were so and the purchaser felt that the value of the goodwill would be gone after he had recovered x years of excess earnings, wouldn't he rather buy municipal bonds and clip coupons (and collect his entire principal at maturity) than work his head off for x years?

I agree with the view that earnings should not be diminished by the arbitrary amortization of the value placed upon the basic ingredient that creates them. The passage of time alone does not require this. But I also see no reason for arbitrarily writing off completely that same valuable ingredient as long as it continues to have value. Since accounting still follows historical cost accountability concepts, shareholders should know what was paid for this asset and whether the company still considers it valuable; essentially, they should know whether the company's earning power was self-developed or purchased—something which would not be evident if a portion of the original purchase price for a part of the business had disappeared because of a write-off of purchased goodwill. They should also know when a purchased segment of a company is later sold whether a loss resulted. The study provides for recovery of the goodwill written off before profits are reflected, but losses on resale of goodwill (the more probable occurrence) are buried forever with the write-off at acquisition.

I recognize the need to deal with the present abuse of the pooling concept but cannot go along with an arbitrary write-off of an incurred cost as a solution. Considerable analysis, on a case study basis, must be made of today's business combinations and of the many factors we conveniently characterize as goodwill before any approach to a solution can be made. The very idea of a single solution for all of these very difficult problems should startle the sophisticated accountant. Research largely based upon past literature is not enough. This study, despite its length, falls short of what is needed. It does not even attempt to demonstrate, by the use of examples, how unacceptable the effect of its solution could be—for example, it is conceivable that the write-off might exceed the total capital of the acquiring company—what would the authors do in such a case?

Comments of Homer Kripke

In 1961 I wrote an article criticizing the wide difference in results between purchase accounting and pooling accounting, and the impreciseness of the tests for their respective applicability under *Accounting Research Bulletin No. 48.* Going beyond Mr. Axelson's present suggestions for restudy by an advisory council representing other accounting-oriented organizations as well as the American Institute of Certified Public Accountants, I then suggested more active participation in restudy of the problem by all segments of the financial community.[1]

Two years later, I was pleased and honored to find myself on this project advisory committee; doubly pleased to be serving on a committee with Professor Paton, who was already an established leader of the profession when I studied accounting under him nearly forty years ago; but on the other hand dismayed to find that my call for broader representation on a restudy had been so little heeded that I was the only nonaccountant on the project advisory committee.

Because in this position I feel a responsibility to make the issues

clear to segments of the financial community other than accountants, I have sought to state my comments in a broader and more fundamental frame of reference than was used (or indeed necessary) for the authors of the study or the accountant members of the project advisory committee addressing themselves to other accountants.

The present study (page 56) correctly recognizes that the pooling—vs.—purchase problem and the goodwill problem are really two divisions of a larger problem—that of accounting for corporate combinations. While technically the present study and the functions of the project advisory committee are concerned only with the second or goodwill aspect, the study necessarily considers the pooling problem as well, and I shall do the same. In addition to the present study, there is already an Accounting Research Study on the pooling—vs.—purchase problem, No. 5, A. R. Wyatt, "A Critical Study of Accounting for Business Combinations" (1963) (herein cited as "Wyatt").

I feel strongly that both Wyatt and the present study come up with unsatisfactory conclusions because they ask the wrong questions. Superficial questions produce superficial answers.

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[1] Kripke, A Good Look at Goodwill in Corporate Acquisitions, 78 Banking L. J. 1028 (1961).

Perhaps this explains the anomaly that: (1) most of Dr. Wyatt's project advisory committee dissented from his conclusions (see the Preface to Wyatt by the then Director of Accounting Research); (2) in the present project advisory committee on goodwill, most of the committee dissent from the principal conclusions of their own authors on the actual subject of the present study, the treatment of goodwill; (3) most of the present committee disagree with Dr. Wyatt's committee and support Dr. Wyatt.

I.

The Possibility of Preserving Pooling Under Carefully Prescribed Limitations Needs Further Study.

A. The Existing Studies Do Not Make a Convincing Case Against Pooling

The general nature and operations of pooling accounting and purchase accounting are well set forth in Wyatt and in the present study and will not now be repeated. Both Wyatt and the present study recommend the abolition of pooling.

But, if one asks the wrong questions as to the reasons for pooling, and gets irrelevant answers, he will reach wrong conclusions.

I feel that the accountants have become involved in sterile controversy in an application of what lawyers call mechanical or conceptual jurisprudence. They have treated cliché rules as providing automatic answers. By attempting to use syllogistic reasoning, they have fallen into the fallacy of syllogistic reasoning known to every logician, namely, that the major premise begs the question. Thus, they have assumed the answer to a question, namely, that all acquisitions require determination of new costs, and therefore they have assumed that if a transaction is an acquisition, then necessarily purchase accounting, and correspondingly the recognition of new costs, is required. To me this kind of "reasoning" gets nowhere, because I question the major premise—I do not assume that it is true that all acquisitions require new costs. It is possible that a different rule should be applicable to acquisitions for a consideration consisting of capital stock of the acquirer, and accountants have not adequately addressed themselves to that question.

Similarly, accountants have argued what is to me a useless question —whether a corporate combination is an exchange transaction and whether something important happens therein. They do this because they beg the major premise by assuming that all exchange transactions in which something important happens must necessarily involve the recognition of new costs, and they are then forced to debate the minor premise—whether a stock acquisition is an exchange transaction in which something important happens. To me the minor premise is self-evident—it is apparent that a merger or a stock acquisition is an important exchange transaction. But that does not decide anything, because I do not accept the question-begging major premise that a new cost must be recognized in every exchange transaction. Accountants have not addressed themselves adequately to the question whether in *this kind* of exchange transaction a new cost *must* be recognized.

Both Wyatt and the present study come to a climax by asking whether there is a significant difference between stock acquisitions and cash acquisitions. Then by an *ipse dixit* they decide that there is not. This, for them, ends the argument, and they propose to outlaw pooling. As will be seen in Part II below, they never reach the deeper and properly decisive question whether the nature and amount of accountability in a transaction of stock issued for stock or assets should make a difference.

In a merger or similar corporate combination for stock, each group of stockholders gives up its sole ownership of a business in exchange for the partial ownership of the other business. It is an exchange transaction on both sides in which something very important happens. There is, therefore, no doubt that the combination *could* properly be accounted for as a purchase transaction in which a new cost *could* be ascribed to the assets, but the question still remains: "*Should* a new cost be ascribed to the acquired assets?" Unlike cash consideration, the amount to be ascribed to consideration in the form of stock is not so clearly quantified as to compel an automatic answer to this question one way or another, as evidenced by the fact that the present acceptable alternatives of pooling and purchase give opposite answers.

Accounting is full of compromises between theory and practicality, and a well-reasoned conclusion on practical grounds that a new cost need not be recognized on an acquisition for stock would not concern me, and ought not to concern accountants. It has not concerned most of the profession for the many years that they have certified statements in which acquisitions were booked according to the pooling of interests concept without recognizing a new cost.

The question then in my opinion comes down to the only solid basis for determining whether purchase accounting or pooling accounting should be required—namely, maximum usefulness to investors and minimum potentiality for abuse and deception. What was the usefulness which caused the pooling theory to be developed and explains its sweeping growth?

Everyone agrees that the standards for use of pooling in *Accounting Research Bulletin No. 48* have rapidly been eroded, as described in both Wyatt and the present study. The Securities and Exchange Commission and the New York Stock Exchange have concurred in this process, and, of course, most accounting firms have done so by their certifications of the financial statements prepared on a pooling basis. The study correctly suggests that pooling is now an available accounting method in substantially every case of an acquisition in which the consideration is voting stock of the acquiring company.

To understand the motivations for this movement toward pooling, one must see the movement against a broader accounting perspective.

Since the debacle of the 1930's discredited the write-ups of assets of the 1920's, accounting has always concerned itself with the historical cost, not the asserted values, of fixed assets. (Inventories are outside the present discussion.) Modern accounting theory has been heavily shaped by the concept that accounting is primarily a process of allocating *costs* and revenues among periods and thereby determining the income for those periods. The balance sheet thus becomes not a representation of values of assets or of net worth, but (apart from cash items and land) a repository for costs not yet charged to the income account, hence little more than a "sheet showing balances."

Many accountants and businessmen have consistently opposed this cost concept, especially in the inflationary period after World War II. They have argued that when the current cost for the items consumed by depreciation is greatly in excess of historical cost, a charge of only historical cost to earnings results in an overstatement of earnings, to the deception of the stockholders. This controversy currently continues, and has been revived more acutely with the recent end of the period of price stability and the beginning of an inflation. Professor Paton's Comments reflect much of this impact of the pressure of rising prices on accounting thinking, and are the more impressive because he was a co-author of the seminal work stating accounting theory as a process of matching *costs* against revenues.[2] But official accounting theory remains firm against recognizing values as distinguished from historical costs in the balance sheet or as the basis of depreciation and amortization charges.[3]

In pointing this out, the writer does not mean to imply any criticism. The literature of 30 years demonstrates the difficulties that would be involved in moving away from a cost basis. Moreover, it must be strongly emphasized that there is no consensus as to which is the most useful measure of income—one embodying a concept of depreciation which discloses differences in actual costs of companies being compared, or one which submerges such differences by basing depreciation on current costs for equivalent fixed assets, without regard to the reporting companies' actual costs. Nor is there any consensus that inflation should be recognized for particular assets by appraisal without an overall index number technique to reflect the effect of changing values of the dollar on *all* of the accounts.

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[2] Paton and Littleton, An Introduction to Corporate Accounting Standards (1940). Professor Paton's present Comments are addressed principally to values, as distinguished from costs, on the balance sheet. That his post-war views apply equally to the amounts in the income statement as charges for depreciation and amortization based on these values rather than costs appears from his dissenting statement of views to *Accounting Research Bulletin No.* 35 (1948).

[3] In *Accounting Research Study No. 6* (1963) the staff of the Accounting Research Division of the American Institute of Certified Public Accountants said:

> "One aspect of the [Accounting Principles] Board's preliminary discussion of the price-level problem is noteworthy. A general feeling was expressed that if price-level changes were to be introduced into financial reporting, the effects on all elements of the financial statements should be disclosed. A piecemeal or partial approach, for example, which would adjust one item and leave all others unadjusted was not viewed with favor. It is to the credit of the accounting profession in this country that it has resisted strong pressures to back partial adjustments which have little or nothing to do with improved reporting of the financial position or results of operations, but instead are designed to buttress a campaign for tax relief or other nonaccounting objectives. These other objectives are frequently worthy of support in their own right and on their merits

Nevertheless, the effect of preserving the historical cost basis of depreciation leads to an anomaly which gives rise to the pooling—vs.—purchase controversy.

Despite the fact that present-day accounting remains anchored to the cost basis of recording fixed assets, it has always been recognized that a new purchase involves a new cost to the acquirer, without regard to the seller's costs. This principle certainly requires a fresh determination of costs when a business or the corporate stock representing that business is acquired for cash. The acquired assets replace the cash (whose carrying value is perfectly clear) on the acquirer's balance sheet and must be stated in the same amount.

The question involved in the pooling—vs.—purchase controversy is whether the acquisition of a business for the *stock* of the acquiring company is also such an acquisition as must entail recognition of a new cost for the acquirer different from that of the acquired company, and if so, how that cost is to be determined.

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but they do not supply a sufficient basis for a change in accounting principles."

It has recently been announced that a subcommittee of the Accounting Principles Board has prepared a "research draft" of an opinion following up *ARS 6*, but its text has not been made public as an exposure draft. Two significant aspects of *ARS 6* were that it asserted that price-level changes should be disclosed as a supplement to the conventional statements; and that restatement on a price-level basis is not a means of introducing replacement costs into the financial statements (*ARS 6*, p. xi). If the Board adheres to these principles in its opinion, the basic problem discussed in the text will be unaffected.

The last formal expression of the Accounting Principles Board on the subject is in its *Opinion No. 6* of October, 1965, where it left unchanged Chapter 9A of *Accounting Research Bulletin No. 43*, which rejected the contention that depreciation should be based on high current costs rather than historical costs.

See also Grady, "Inventory of Generally Accepted Accounting Principles for Business Enterprises," *Accounting Research Study No. 7*, 252-258 (1965).

See also the statement of the Accounting Principles Board dated April 13, 1962, where it announced that it was taking no action on *Accounting Research Studies 1* and 3, each of which bore the name of the Institute's then Director of Accounting Research, and each of which contained language tending toward support of periodic appraisal restatements of fixed assets.

The opposition to recognizing a new cost comes from the fact that such recognition destroys the basis on which the earnings of the acquired company were computed. By changing the recorded cost of the assets of the acquired enterprise, it changes their annual depreciation and amortization charges. If, in addition, goodwill is recognized and amortized, as discussed in the study, the income charges rise even higher. These circumstances are aggravated by the fact that these additional charges (for depreciation and amortization of goodwill) are not deductible for tax purposes; instead, following a tax-free transaction the acquiring corporation inherits the basis of the acquired entity. Thus, accounting for the acquisition of a going concern on a purchase basis produces the anomaly that that concern's continuing gross revenues produce a very different amount of net income, because of accounting requirements as to non-cash charges to income for depreciation and amortization. This result is inevitable for a cash purchase, but the pressure for pooling evidences that the fact is not willingly accepted for a stock acquisition negotiated in terms of preserving the per-share earnings of the issuer. In modern corporate affairs an acquisition is negotiated in terms of acquiring earnings, and the result of purchase accounting is to destroy what is being acquired.

Thus purchase accounting in a stock acquisition seemingly fails to live up to the pragmatic postulate of accounting—it is not *useful* to have accounting principles that destroy earnings in the process of acquiring them, by changing the measuring rod for periodic charges against earnings to measure the exhaustion of assets. Something seems to be wrong with one or the other measuring rod.

In an ideal world it might be appropriate for accounting to stress its theory that it accounts for *entities*, and that the earnings should not be expected to be the same when the entity has changed by an exchange. But accounting so conceived is seemingly not useful, because the investors for whom it accounts do not understand why a stock acquisition should establish a new basis of accountability. Unless accountants make a more impressive argument on that point than they have yet made (see Part II), the public will not readily accept the concept that earnings are destroyed by the process of acquiring them.

The tremendous pressure for pooling, which rapidly led to the erosion of the standards of *Accounting Research Bulletin No. 48*, was due to the fact that the persons planning corporate mergers or other acquisitions wanted to be able to figure the consequences of the acquisition by adding together the individual operating results of the companies involved and calculating a hoped-for improvement in the "bottom line," i.e., earnings per share. They did not want their basis for calculating an acquisition destroyed, with the combined earnings of the expanded group worse than the sum of the former separate amounts. Such a worsening would arise from purchase accounting by reason of ascribing new costs for fixed assets and for goodwill, with the result that additional charges for depreciation and amortization would reduce reported earnings.

Such a result appears irrational, and must lead to a questioning of the very basis of present purchase accounting namely, that assets are recorded at cost; and that a change in price level, no matter how well documented, does not justify recording it in the accounts; but an exchange transaction for stock consideration, although it produces no significant additional objective evidence for requantifying particular assets, requires such requantifying. The situation would be rationalized if a new accounting amount for a fixed asset were to be recorded not only after an exchange but also after a change of value without an exchange, and if depreciation were based on these amounts. In that event, the depreciation charges of both separate enterprises before combination would already be affected by current asset values, and the combination would not produce the seemingly irrational result that new accounting amounts destroy earnings in the process of acquiring them.[4]

Yet it is clear that accounting is not presently prepared to record value changes in the absence of an exchange transaction, and that purchase accounting puts decisive weight on the exchange transaction, no matter how little objective evidence of value that transaction supplies (see Part II). Pooling is a device for rationalizing the situation in the other direction, i.e., by rejecting new accounting amounts even when there is an exchange transaction for stock consideration.

B. An Attempt Should Be Made to Restate the Rules for Pooling to Prevent Abuse

The trouble with pooling is not in the theory itself, as thus explained,

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[4] I am not here taking a position on this fundamental question. I am merely emphasizing the overwhelming importance that purchase accounting now places on a type of exchange transaction which provides no new objective basis for restating the assets.

but with the abuses to which it has repeatedly been subjected. *Accounting Research Bulletin No. 48* tried to limit disparity in size of the constituents to a pooling to a 95-5% or 90-10% factor. Even these standards have been eroded until there have been "poolings" where one party was very substantially less than 1% of the size of the other. At this point, the theory of pooling as distinguished from a straight acquisition of new assets becomes a farce. There have been instances of corporate empire-building when the acquiring company acquired assets without any intention of keeping them, simply to sell them promptly and show a profit from the divergence between the low costs carried over under pooling and the values inherent in the properties acquired (for which the acquiring corporation paid fully with stock). There have also been poolings where the old costs were less than the par value of the stock issued in exchange, producing a monstrosity where this deficiency had to be made up by transferring earned surplus to capital. There have been poolings where the high market value of the stock issued was used to recompense management in a "think tank" for their future services, and the tangible assets acquired were insignificant in amount. Instances where the stock used was recently acquired in the market have also frequently arisen, and where the costs recorded for the assets under the pooling principle were less than the cash paid, the difference being absorbed in the capital accounts. Professor Abraham J. Briloff has convincingly demonstrated these abuses, and has argued that the concealment of costs by these devices and resultant inflation of earnings is the sparkplug for the whole modern drive of the conglomerates for corporate acquisitions.[5]

[5] See Briloff, Dirty Pooling, 42 Acctg. Rev. 489 (July, 1967); Briloff, Distortions arising from Pooling of Interests Accounting, Financial Analysts J. (March-April, 1968); Briloff, Dirty Pooling, Barron's July 15, 1968 p. 1. Briloff also blames pooling for the misleading sales and income comparisons published by some companies, showing large percentage increases from year to year without disclosing that the result comes from acquisitions, not internal growth, between the periods compared. In a narrow sense, this criticism is not justified, because the same opportunity for deception could come from any acquisition, even cash purchases. But to the extent that Briloff is right that pooling is the sparkplug for our modern phenomenon of companies whose business is acquisitions, Briloff's criticism here too is justified.

So pooling has been abused. The obvious conclusion is that an attempt ought to be made to cure the abuses by new rules controlling its use before it is abandoned.[6] I could not support pooling if its use could not be disciplined, but no one could know the answer until the question was seriously considered.[7] The past extensive use of pooling suggests that there may well be suitable circumstances for the continuation of this seemingly useful practice by which the assets of the companies in combination are pooled without a reaccounting that makes all past earnings history irrelevant. Wyatt and the study never seriously address themselves to this question.

C. Preservation of Pooling Will Be Useful Where Purchase Accounting Is Inappropriate Because of Atypical Markets

Preservation of pooling in appropriate circumstances would have certain beneficial advantages. While it is commonly said that the purchase accounting alternative is *always* available, Andrew Barr, Chief Accountant of the Securities and Exchange Commission, has cited cases where the SEC required pooling.[8] So long as accounting theory equates market value of stock with value of assets (discussed in Part

[6] Even Briloff does not argue for complete abandonment. He argues for limitation of pooling to cases where the size disparity does not exceed 70-30. See also Parkison, Accounting for Corporate Combinations and Related Goodwill (Dissertation for the degree of Doctor of Business Administration, Indiana University Graduate School of Business, 1967) suggesting a 60-40 size disparity maximum.

[7] The difficulty may lie in the present status of the relation of accountants to the management of their corporate clients under existing concepts, where conflicting or ambiguous principles may exist, and the accountant is entitled (in fact constrained) to certify the client's statements if the client's management group chooses that principle which best suits them. Until the independent accountant is required to certify that the accounting principle used is that which he himself would select, and not merely one which the management has selected and which the independent accountant can conclude to be within generally accepted accounting principles, it may be impossible to enforce any criteria of suitability in accounting.

[8] Barr, Accounting Aspects of Business Combinations, 34 Acctg. Rev. 175, 180-181 (1959).

II hereof), this is the only protection against abuse in aggravated cases.[9]

D. Required Purchase Accounting in Acquisitions Will Lead to Abandonment of the Cost Basis of Accounting for Fixed Assets

Accounting is in many respects a product of experience and expediency rather than strict logic, and it would be foolhardy to predict that one accounting step *will inevitably* lead to another. But it is possible to argue that one step *should logically* lead to another.

To make purchase accounting the norm for stock acquisitions should force accounting into abandonment of the convention of carrying fixed assets at cost, and lead to the periodic re-recording thereof at appraised values. This might or might not be a good thing, depending on one's views on the ultimate question (see notes 2 and 3, and related text), but at least interested persons should understand the logical consequences of the decision about to be made.

1. There Is No Logical Basis for Not Restating the Accounts of Both Parties to an Exchange Transaction.

In the first place, the basic theory of the study is that a stock acquisition is an exchange transaction. Obviously so. But an exchange is a two-sided transaction. Each former group of stockholders exchanges part of its exclusive ownership of its company for a partial interest in the combined enterprise. It is an acquisition on both sides, and there is equivalent objective evidence of the values of both companies negotiated in an arm's-length exchange on both sides. This would seem to call for reaccounting for the recorded fixed asset amounts *on both sides*, and Wyatt and the study recognize this if the combination appears to be a new enterprise. But they say that this result is not necessary if one of the former components can be identified as the continuing company and its assets may continue to be

[9] The writer had a case in practice involving both SEC and the accounting firm of the authors of the study. A prior management had insisted on purchase accounting for several stock acquisitions when the market price of the company's stock reflected the frenzied market for untried issues of early 1962. After the 1962 market crash the recorded amounts for the assets acquired were ridiculous on the basis of the then market and the earning power of the assets. The new management, the accountants and SEC all accepted the writer's suggestion for reaccounting on a pooling basis.

stated at cost. The whole program thus depends on the ability of accountants to make the metaphysical determination when there is a new enterprise, and when, on the other hand, one constituent old enterprise is the survivor, and which one it is.

2. *The Proposal for Determining Which Is the Surviving Company Depends on a Subjective Test Capable of Manipulation.*

No doubt it is reasonable to assume, as the study does (page 62) that if one company is clearly the larger, it is the surviving company.[10] The common sense evaluation the study recommends will support that conclusion. But, surely, it is metaphysical, not factual, to assert that if their relative size is "similar" on the basis of objective tests, one of them can be recognized as the continuing corporation. Common sense does not point to any certain conclusion in such cases, so the matter would have to be decided on the basis of the remaining test suggested, "whose management takes control."

This controlling factor is a subjective test to which there might be no clear answer when Chairmanships, Executive Vice Presidencies and other badges of authority are judiciously apportioned, and when the distinction between real authority, window dressing and assuaged pride may not be discernible. A vigorous executive from the small company might tilt the scale on this test, producing an accounting monstrosity where the objective standards pointed the other way. More important, it is not apparent why vigor of management should control for the future which of two companies should retain its old costs and its old annual exhaustion charges, and which should have these amounts restated on the basis of current values. Even the objective standards of size are not necessarily indicative as to which company has the larger discrepancy between recorded costs and current values—i.e., which one will produce the larger shock to earnings if designated as the acquired company.

It is hard to believe that adoption of the indicated standards would not leave corporate managements free to arrange matters so that if the objective factors are at all inconclusive, they could pick either one constituent or both for reaccounting, with tremendous impact on the

[10] The fact that X is the surviving company for accounting purposes, although large X merged into little Y, or little Y bought large X, will obviously create nightmares for lawyers. No legal study has yet struggled through this problem. See also the next footnote.

result.[11] The logic should lead to reaccounting for the fixed assets of both constituents in all cases.

3. If Exchanges Produce Restatement of Fixed Assets on the Basis of Stock Market Values, So Also Should Market Values Without Exchanges.

At that point, under the theory of the study that stock market prices show underlying asset values, it will be hard not to take the logical next step. The study and the entire purchase technique call for quantification of the separate assets acquired on the basis of current values rather than old costs; but there is no arm's-length bargain that determines these values other than the overall quantification of the trade which the study finds in the market value of the securities issued in exchange. Therefore, resort must be had to appraisal or other techniques to fix the new recorded amounts for the separate assets. Essentially, the same situation exists as to the assets of any company which has a quoted market for its stock—namely, that the overall value of its assets can be determined, on the study's theory,[12] from

[11] See Barr, Business Combinations and Other Financial Reporting Problems (an address before the Chicago Control, Controllers Institute of America, Jan. 8, 1962, mimeographed) at 11-12, giving this actual case: A acquired the assets of B, accounting on a pooling basis. On a purchase basis the excess purchase price would have been $20,000,000 and on a 10 year amortization thereof the charge would have been 12½% of pro forma combined earnings or 250% of the earnings of B.

But, suppose, as Mr. Barr says, "for some good reason"—e.g., on the study's principle, because the management of B was more dynamic—B is deemed to be the surviving corporation. Then the revaluation excess would be $200,000,000, and the annual amortization charge would be $20,000,000, or 120% of combined earnings and 125% of A's earnings.

Or suppose on the study's test neither management is dominant, so we treat the combination as a new enterprise and revalue both companies. Then Mr. Barr computed that the excess valuation would be $220,000,000, which would take 130% of combined pro forma earnings for amortization.

Amortization on a 20-year basis would make the variations as to choice of companies for reaccounting less fantastic, but dramatic enough.

Again these tremendous amounts pose the question as to the desirability of reaccounting for such value changes with or without an exchange transaction.

[12] Of course, the writer disagrees with the study's theory for the reasons set forth in Part II.

the quoted market for the stock. The same appraisal techniques are available to value the assets. There seems to be no justification for requiring a corporate combination as the occasion for recording the asset values, for the corporate combination does not quantify the separate assets any more than the market price does at any given moment. Thus, on the theory of the study, there is no reason not to have periodic revaluation of fixed assets for every enterprise for which an aggregate value of all the assets can be determined from a market quotation of stock. The conclusion of the study thus leads by every process of logic to a fundamental revolution in accounting for fixed assets (supra, note 3 and related text). There is not yet any consensus as to the consequences of such a revolution on the meaning of accounting concepts of income and on the financial analysts' process of determining value by capitalizing income. There has been little discussion of the problems of determining values without the benefit of an arm's-length negotiation directly for the specific assets, in order to avoid recurrence of the evils of the appraisals of the 1920's.

E. Many Corporation Statutes Embody the Pooling Concept

Corporation law has been remaking itself by lawyers' efforts to accommodate the statutes to the pooling device of the accountants, especially on the question of carrying forward the earned surplus of the acquired company.[13] It is no easy matter to formulate and put through a statutory amendment. Fortunately, pooling is at most permissive in nearly all cases, both as a matter of accounting and as a matter of law, and its abolition by accountants would not necessarily require a second effort to repeal the statutes equal to the lawyers' original effort to enact them. Yet the study's cavalier treatment of this problem is not encouraging for the future necessary interdisciplinary cooperation in matters of mutual interest to lawyers and accountants.

[13] See, e.g., Gormley, The Pooling of Interests Principle of Accounting—A Lawyer's View, 23 Bus. Law. 407 (1968); Gibson, Surplus, So What—The Model Act Modernized, 17 Bus. Law. 476 (1962); Stanger, Accounting Concepts and the Standards for Declaration and Payment of Dividends under the New York Business Corporations Law, N.Y. Law J., Dec. 1, 1966; Hackney, Financial Accounting for Parents and Subsidiaries—A New Approach to Consolidated Statements, 25 U.Pitt.L. Rev. 9 (1963).

II.

The Market Value of the Acquiring Corporation's Stock Is Not Necessarily the Proper Measure of Accountability for the Acquired Assets. Further Study Is Needed to Determine a Proper Measure.

To repeat, if accountants abolish pooling, they ought to explain to the financial community and the investor why earnings must be destroyed in the process of acquiring them. This is easy in the case of a cash acquisition. There is a new cost undebatably equal to the cash, and annual exhaustion charges must recover that new cost. *But what is the cost of assets acquired for stock?*

To this question, *Accounting Research Bulletin No. 48*, in talking about purchase accounting, gives a response which is no answer: "... the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more clearly evident." The study and accountants generally assume that this calls for use of the market value of the issuer's stock, without further discussion,[14] and neither Wyatt nor the study gives any detailed consideration to whether this should be so.

It is fair to say that the heart of the study is the repeated assertion that stock is just a substitute for cash, and most acquiring companies could have sold the stock issued in an acquisition for cash equal to the quoted market. The heart of my disagreement with the study is my conviction that this is not so.

We may take as our theme for this topic the views of a great accountant[15] quoting a great lawyer:[16]

> "The capital stock of a corporation, its net assets, and its shares of stock are entirely different things. The value of one bears no fixed or necessary relation to the value of the other."

The study takes it for granted that the new cost must be based on the

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[14] Wyatt, however, is far more circumspect than the study and most accountants, and expressly refuses to assume that market value is automatically the measure of the new recorded amounts for the fixed assets. Wyatt 91. But he does not probe the question beyond this point.

[15] George O. May, Losses as a Cause of Gain—With a Footnote on "Value," 72 J. Accountancy 221 at 227 (1941).

[16] Mr. Justice Brandeis in Ray Consolidated Copper Co. v. United States, 268 U.S. 373 (1925).

market value of the stock issued, or released from the corporate treasury, on the theory that the stock could have been sold for cash for this amount. This certainly is not universally true. Could our great conglomerates have marketed for cash the huge quantities of stock they have been issuing in frenzied acquisitions? Many other issuers could not successfully market a large issue at anything near the market price determined by the small trading supply. It is commonly said that the stock market is short of merchandise—that institutional investors remove so much of the trading supply of prime securities for their portfolios that quoted price levels reflect the shortage. Moreover, at the historically high price-earnings ratios enjoyed in recent years by many stocks, underwriters would be most reluctant to underwrite at a fixed price without a preliminary rights offering to stockholders, which insures the success of the issue by pricing it 10 or 15% below the quoted market. Moreover, the market price tends to go down while a stock is being registered for cash sale in expectation of an increase in the supply. Finally, the expense of registration and the underwriting spread on a common stock issue are not insubstantial. As generalization, it certainly cannot be assumed that the market price of a few shares traded per day or per week is the measure of what the issuer is giving up when it issues a large block of stock for assets.

I reject utterly the intimation of the study (page 13) that market price of shares traded affords a measure of the value of underlying assets sufficient for accounting quantification purposes. Is it only the value of a business as estimated by a trader that determines his views toward the company's stock? His view of the price of any given stock is influenced by his expectations of the movement of the market as a whole (i.e., a guessing game as to the expectations of other investors); of the movement of other individual stocks that might provide an outlet for his funds; of the future course of national income and population, commodity prices, levels of taxation and of interest rates, extent of regulation, balance of payments, and all other economic factors. His view of the market or of this particular stock may also be affected by technical factors having nothing to do with the worth of the company, such as existence of short interests or margined holdings, the predominance of odd-lot purchasing or selling, or past market history and the manner in which it matches the theories of some chartist. The overall market and with it any particular stock may fluctuate sharply in a day or over several months with a national mood affected by the imminence of an election, dissatisfaction with a war, a feeling of impotence of Congress.[17] Is it not ridiculous that an accounting profession which has adopted such rigid rules of examination before certifying inventory and receivable should propose to quantify huge acquisitions on the basis of fluctuating market prices for relatively small quantities of traded stock?

Once one eliminates the theory that the stock of the issuer issued on an acquisition could have been sold for cash at the quoted market, no new cost for the assets can properly be computed solely from the market quotation for the issuer's shares multiplied by the number of shares issued. The stock may be so overpriced that neither the owners of the acquired company nor anyone else would have been willing to buy any such number of shares at that price for cash. The owners accept shares at that price only because they are obtaining a high price for their own assets, when so measured. Thus, the trade is measured in inflated currency, and the inflated amount is no fair measure of the assets acquired. Moreover, the controlling persons of the acquired company are restricted by SEC "control" concepts and are not free to sell their acquired stock except in a small amount. See SEC Rule 133. Thus, they do not acquire a marketable security

[17] The following quotation from Chicago Corp. v. Munds, 20 Del. Ch. 142, 172 A. 452 (1934) is even more applicable to asset values determined by market prices of stock than it was for the intrinsic value of the stock:

> "When it is said that the appraisal which the market puts upon the value of the stock of an active corporation as evidenced by its daily quotations, is an accurate, fair reflection of its intrinsic value, no more than a moment's reflection is needed to refute it. There are too many accidental circumstances entering into the making of market prices to admit them as sure and exclusive reflectors of fair value. The experience of recent years is enough to convince the most casual observer that the market in its appraisal of values must have been woefully wrong in its estimate at one time or another within the interval of a space of time so brief that fundamental conditions could not possibly have become so altered as to affect true worth. Markets are known to gyrate in a single day. The numerous causes that contribute to their nervous leaps from dejected melancholy to exhilarated enthusiasm and then back again from joy to grief, need not be reviewed. . . . Even when conditions are normal and no economic forces are at work unduly to exalt or depress the financial hopes of man, market quotations are not safe to accept as unerring expressions of value. The relation of supply to demand on a given day as truly affects the market value of a stock as it does of a commodity; and temporary supply and demand are in turn affected by numerous circumstances which are wholly disconnected from considerations having to do with the stock's inherent worth."

unless the issuer agrees to register it under the Securities Act of 1933. A nonmarketable security is worth considerably less than the then quoted market price of the same security freely marketable. This too affects the value of the consideration issued, and that value cannot be determined from the market value of comparable shares not restricted as to marketability.

I have not yet discussed goodwill, but it should be noted that, as the study concedes, the market price of the acquiring company's common stock reflects self-created goodwill. If that stock value is ascribed to the acquired assets, a portion of the self-created goodwill is put on the books, contrary to a firm principle of accounting, by being wrongfully ascribed to the assets acquired instead of to the earning power of the original entity.

It is time that accounting put aside this delusive certainty that the measure of quantification can be derived universally from the market value of the stock. What should be the recognized cost to the acquirer? What should in principle be the recorded amount for assets acquired for stock consideration? Should it be the cost of printing the stock certificates? Should it be the book values on the books of the acquired company—i.e., pooling? Should it be an amount sufficient to maintain book value per share of the acquiring company? Should it be an amount sufficient to maintain existing asset value per share for the acquiring company? Should it be an amount sufficient to maintain earnings per share for the acquiring company, after exhaustion charges for the new assets based on the determined amount? When the issued stock could truly have been sold at the quoted market price, should it be that amount?

Briloff has suggested another approach, which indeed was hinted at in the study (pages 75 to 76) and in Wyatt (page 91). Briloff argues that the management should be held accountable to stockholders for the amount at which the stock was valued in the acquisition negotiation. Granted. But does the measure of accountability of management define the proper accounting amount for the stock and hence of the assets acquired? Accounting has long since ceased to be merely a report of stewardship by management to stockholders. Some stockholders and all prospective investors will be uninterested in the question of accountability of some present or past management for past events; they want to know whether to buy now, sell now, or retain the corporate stock. For that purpose their question is what exhaustion charges are properly applicable to the assets acquired, a question to which the accounting or economic answer cannot depend on the legal or moral accountability of management. Accounting, too facilely accepting a market value figure, has never faced this question with any meaningful discussion, and its literature is blank on the subject.

There is another possibility for valuing the stock issued in an exchange, an answer so simple that it should be obvious, namely, the value of the assets given in exchange, determined by appraisal or otherwise. At this point, I would accept Professor Briloff's thinking that to the extent that the trail of the negotiations may show specific agreed tangible asset values and specific intangibles being acquired, these values ought to be recorded and accounted for. See also my concurrence in Professor Paton's Comments, infra page 143.

This same conclusion may be stated in another fashion. Going back to *Accounting Research Bulletin No. 48*, we find accounting too readily assuming that the value of the consideration, i.e., the value of the capital stock of the acquiring company, is more clearly evident than the value of the assets acquired. This is not so, as we have seen, for we do not even know by what standard to value the stock, after rejecting the delusive standard of quoted market price. Let us therefore take the other option offered in *ARB 48*, quantifying the transaction at the value of the assets received, thus reaching the same conclusion as the preceding paragraph. This approach does not introduce the evils of appraisals of assets. The possibility of that evil is inherent in present-day purchase accounting for corporate combinations. The specific values of the assets acquired have to be determined by appraisal or other appropriate methods even under the stock market price theory. The market rule, even though objective, does not objectively quantify individual assets.

If we value the assets acquired instead of the stock under the rule of *ARB 48*, we do not create an excess labeled goodwill, and we completely avoid the struggle of the study with the question what to do with goodwill when created.

Thus, I would get to the result of the study—i.e., specific assets acquired to be valued on a current value basis (where pooling is not appropriate), creating no goodwill to be shown on the balance sheet or amortized against earnings—but I reach the result in a manner far more logical and acceptable to the structure of accounting theory.

This brings me finally to the study's treatment of goodwill.

III.

If Goodwill Is To Be Recognized, It Should Be Charged Through the Income Account by Periodic Amortization Charges.

In my view, all accounting discussions of goodwill suffer from a fallacy of nominalism. They assume that there is a something called "goodwill" because it has a name and a library full of attempted definitions. To me, the concept of "self-created goodwill" is useless for analysis. Except where it describes the fact that specific intangibles like research and development costs have been charged off but have continuing utility, the term seems to be used as a name for the fact that the market price of a company's shares multiplied by the number of shares is greater or less than some assumed value or some recorded amount for the assets (study, page 13). Since market price of stock fluctuates for all of the company-related and non-company-related factors mentioned under Part II and has little relation to asset values, it is obvious that self-created goodwill is not any concept with which accounting can be concerned.

I find little meaning in the discussions in the study and in accounting literature generally as to whether purchased goodwill and self-created goodwill are identical in nature, whether their treatment should be identical, whether goodwill pertains to the accounting entity or to its stockholders, whether purchased goodwill is a wasting asset which is replaced by self-created goodwill. The most meaningful concept of purchased goodwill is that it is a name for that portion of the cost of a group of earning assets in combination which is not ascribed to the determined individual asset costs. On this view, amortization of this segment of cost is clearly required along with other elements of the cost of the assets.

A related but slightly more sophisticated concept is that ordinarily physical value of an asset is limited by a normal rate of earnings therefrom, and that purchased goodwill is the portion of cost not ascribed to individual assets because it is a payment made for the expectation of future earnings of the group of purchased assets in excess of that normal rate of return—i.e., it is the capitalized value of utility which is in the future. It is, therefore, something in the nature of a receivable, although it is not legally or technically a receivable—so the cost is, in effect, being recovered as the "receivable" is being collected.

I, therefore, fully agree with Mr. Seidman's Comments. I agree with his comparison of purchased goodwill to premium on a bond, which has to be preserved in cost until amortized, and must be amortized, to avoid overstating earnings and yield. Accordingly, a direct charge-off thereof to surplus would relieve year-to-year earnings of proper charges. I cannot accept the view that payment of a premium over specific asset values in expectation of abnormal yields is somehow a reduction of stockholders' equity chargeable immediately to the capital accounts,[18] instead of a cost to be recovered through periodic charges to earnings.

I also agree generally with Professor Paton's Comments. Much of what the study calls goodwill can be recognized to be more specific intangibles—research and development, advertising, promotional expense, or other expenditures which are not reflected on the balance sheet but which still have remaining utility. The fact that they may have been charged off in the past should not affect the recording thereof by the acquiring company at their appraised or negotiated values where purchase accounting is being used. This leads to the reflection that each of these more specific intangibles, if separately recognized, would necessarily be amortized over a limited period. It would be anomalous if different accounting treatment resulted where the intangibles were lumped under the heading "goodwill." The financial statements and earnings could then be controlled by judgmental factors or by other considerations in determining the amounts and classifications.

Thus, if my views as set forth in Part II are rejected and goodwill is recorded, I would require the goodwill to be amortized by annual charges to income, consistent with the way in which the "expectations" or "inchoate receivables" were capitalized. A suitable maximum term would be 20 years, which is in line with the multiples used in the more conservative capitalizations of income.

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[18] It is impressive that the study pays no attention to the exact means of determining market price, and hence the exact amount of goodwill purchased, thus disregarding some prior accounting suggestions for using an average market price for a period. The study can do so because under the study's conclusions, the goodwill disappears instantaneously anyway. Its amount is unimportant: The study permits immediate charge-off to capital surplus or earned surplus. Obviously, the charge would be to capital surplus, and the amount needed would automatically arise in sufficient amount from the same valuation process, unless the lawyer on the job was awfully inexpert in picking his stated and par values of capital shares.

Comments of William A. Paton

The central proposal of "Accounting for Goodwill" by Messrs. Catlett and Olson is that the portion of the total value of an acquired enterprise assignable to intangibles be immediately disposed of by reducing the stockholders' equity of the acquiring corporation in corresponding amount. This proposal is fundamentally objectionable, and the authors do not make a good case for their position.

Nature of Business Assets. The starting point in passing judgment on the authors' thesis is found in the nature of business resources. Assets are not inherently tangible or physical. An asset is an *economic quantum.* It may be attached to or represented by some physical object, or it may not. One of the common mistakes we all tend to make is that of attributing too much significance to the molecular conception of property. A brick wall is nothing but mud on edge if its capacity to render economic service has disappeared; the molecules are still there and the wall may be as solid as ever but the value is gone (ignoring possible net salvage).

The application of a proper conception of business resources to a study of intangibles, including goodwill, is fairly plain: the distinction between tangibles, so-called, and intangibles, so-called, is not a fundamental line of cleavage. In principle, the intangible asset is just as admissible to the respectable, recognizable company of business property as something you can stub your toe on. This point should be stressed, not submerged, in any analysis of the nature of the intangibles.

It is a convenience to be able to associate asset quanta with specific physical objects, or groups of objects, and full advantage should be taken of this possibility in business accounting. But the view that if such association is impractical the segment of value under consideration is invalid or suspect is unwarranted.

Kinds of Intangibles. There is, of course, much more to the subject of intangibles than a sketchy discussion of goodwill. Using the term very broadly, money and money claims, ordinary receivables, and holdings of securities and related assets, may be labeled "intangibles," but such resources have distinctive features that warrant their segregation as a special class. (Thus there are really three main types of business resources: (1) the "monetary" assets; (2) the asset values represented in inventories, buildings, and other physical objects, including natural resources; (3) the intangibles.) But even with this exclusion the intangible area remains a broad field—broader than conventional analyses and procedures suggest.

One important group of intangibles is that representing the value of sales promotion and selling activities clearly applicable to future deliveries of product. Encouraged by acceptance for many years of the view that selling costs, including advertising, are generally deductible for tax purposes in the period in which incurred, conventional accounting has long been on an arbitrary course in this area. The fact remains that it is basically improper to include in current operating costs substantial amounts that are clearly associated with future product shipments, and in connection with business enterprise transfers and combinations the rights of some of the parties involved may be impaired by slavish adherence to the conventional—and illogical—procedures. A very prosaic and obvious example is found in order-taking effort. In many cases a substantial cost is represented by the activities of the order-taking staff and of course this cost should be assigned to the periodic deliveries of product to which it relates—not an especially difficult cost accounting chore. And even if this is not done year-by-year in either tax measurement or financial reporting, it is just plain folly to ignore the existing asset at a particular point when a business is being sold or merged. There are plenty of examples in practice where order-taking cost of substantial amount ($100,000 or more) has been completely overlooked at the expense of the equity of the transferor's stockholders.

Dealing realistically with advertising and other marketing promotion programs is of course more difficult than the periodic allocation of the cost (or value) of activities related to particular orders for product, but it doesn't follow that the problem should be ignored. What is badly needed is the encouragement of careful study and analysis instead of adoption of the easy-going view that general "goodwill" is all that we can find in the area of intangible resources. I am satisfied that in many enterprise acquisitions or merger situations a major slice of the total value of the acquired company consists of the momentum achieved by marketing research and related factors and should be dealt with as such—not thrown over the shoulder as part of a "goodwill" limbo.

The above comments on the relation of intangible values to marketing activities and processes are made because this area has been somewhat neglected and not because it is the most important. As we all know, a great deal of the expenditure and effort which result in the endowment of a business with intangible values is connected with the more technological phase of operation. In addition to those values which inhere in physical objects such as specific machines, a business may come to have substantial worth as a result of formulas, engineering methods, special processes, and other factors which facilitate efficient production, including those covered by governmental grants such as patents, and private contracts. A commonplace example in this general area, in which accountants should be especially interested, is the complex which is nowadays referred to as the "information system" (a factor that it is quite unreasonable to exclude from recognizable assets—although we all do it).

Mention should also be made of the value of organizing and launching a business entity, including financing services. Although often dealt with arbitrarily, partly as a result of tax rules, this factor is a valid asset of the going concern, and a part of the price paid for a business may generally be attributed to this factor. In *Asset Accounting* and elsewhere the writer has presented the case against suppression of this resource, and has given special attention to the folly of canceling the cost of financing services against stockholders' capital.

The purpose here of the above remarks about "kinds of intangibles" is to open the door to the view that in many business enterprises that have a total value in excess of the amount assignable to physical resources, plus the monetary assets, a major part of such excess could—as a result of a careful study of the circumstances—be attributed to technical research and development momentum, values of patents and related factors, marketing research and promotion activities (including order-taking), information system, and other special intangible areas that cannot reasonably be referred to as general goodwill, and that, moreover, are clearly related to operating processes and the costs of operation. In the treatment of business acquisitions by purchase or combination, it is my observation that not only are ordinary tangible assets often understated (familiar examples are land and other natural resources) but the possibilities of assigning a major part or all of the intangible value included to specific factors such as patent rights are not explored.

Relation of Value of Intangibles and Earnings. The efforts of the authors to build a wall between recognizable assets, related to business operation, and intangible value (a value perhaps significant to investors but not an asset for accounting purposes) are a failure. They lean heavily on the assertion that "goodwill" has no relation to the "profit-making" process—"is not a resource or property right that is consumed in the production of profits." This claim is unrealistic and at odds with the basic relation of costs and revenues (selling value of delivered product). We all know that, broadly speaking, total periodic revenue is an amalgam that generally can't be attributed or assigned to particular assets or cost factors except in a hypothetical, arithmetic sense. (Here, of course, is the reason why divisional and departmental allocations useful for certain control purposes must not be taken too seriously.) And the same thing may be said about the relation of particular assets and cost factors to *net* earnings.

It is true that the existence of intangible value has usually been equated with the assumption of a superior earning power, which amounts to acceptance of the view that so-called tangible resources generally stand in a preferential position with respect to the soaking up of earnings, especially when it comes to a consideration of the broader and more imponderable factors in the intangible package. But, as has been pointed out by those dealing with basic analysis in this area, this is sheer assumption. In a given case it may well be that it is the intangibles that are crucial in the generation of revenues and net earnings, not the prosaic stock of tangibles. Who knows?

But even if we conceive of total revenue as a bundle of recoveries of various assets consumed or exhausted during the period of reckoning this would afford no warrant for throwing out selected factors. Suppose, for example, that Co. A acquires some valuable formulas and processes from Co. B, and in terms of a reasonable dissection of a total transfer value, the amount of $1,000,000 is determined to be the cost of this factor. Assume further, that in view of all the circumstances, including competitive pressures, the potency of this factor will presumably be greatly impaired or exhausted over a ten-year period. Surely in these circumstances it is not only appropriate but imperative that as periodic revenues emerge the annual amount of $100,000 (using straight-line for simplicity) must be included in expenses, whether or not there is an identifiable slice of gross attributable specifically to the use of the formulas and processes.

Carrying the point further, let's assume that Co. A pays Co. B $1,000,000 for a bundle of factors of such complexity that it seems to be expedient to treat the payment as a general intangible ("goodwill," if you like). The value is determined and the payment is made because of the prospect of a layer of fat in the earnings over the next few years. In this situation it would obviously be unsound to ignore the existence of the intangible factor, and the appropriate amortization, as this would result in a definite overstatement of the amount of periodic earnings, and the earning rate.

With reference to goodwill amortization it may be noted that this study does not include any survey of the controversy regarding this matter in the tax field a half-century ago. The fact that the courts went astray does not justify the conclusion that acquired goodwill may not properly be regarded as an amortizable asset.

Importance of Resources—Need for Sound Measurement. As a result of the current preoccupation with income and taxes it is sometimes forgotten that the basic factor in business operation consists of the available resources or assets, purportedly shown on the left-hand side of the statement of financial position (balance sheet). Thus it may reasonably be urged that the most important accounting measurement is the determination from period to period of the amount or value of the assets. As every accountant knows (although not always acknowledging it) there is an intimate connection between asset accounting and income accounting; indeed the measurement of income is largely a reflection of the policies and methods of recognizing and expending resources acquired. Moreover, as is being increasingly acknowledged, the underlying measurements in dealing with the problems of business management—in making decisions as to direction of activities, production procedures, and so on—are the asset requirements for the particular department or segment of operations, or for overall activity.

Of special importance is the fact that degree of operating success can only be ascertained by determining the relationship between earnings, actual or prospective, and employed or required assets. It isn't the amount of dollars of income that is significant, but rather the *rate* of earnings—earning power. This homely truth is often forgotten by the layman and is noticeably neglected in present-day accounting and reporting. It needs also to be emphasized that it is the percentage of earnings to the *current value* of the resources utilized, rather than to "cost" or "book value," that is significant. The degree to which this fundamental point is overlooked in practice, either deliberately or otherwise, is nothing short of scandalous. Government agencies, accountants, and management (to some extent) combine forces to prevent the investor or owner from knowing the facts of life. Flagrant examples come to light whenever a searching inquiry is made. Understatement of marketable securities, land, and timber are commonplace, to say nothing of inventories and plant. Cases can be found in which major resources are reported at a quarter—or even less—of their unquestioned current value, and application of earnings figures to such understated assets do not give even a clue as to how well owners or investors are doing. Among many manufacturing companies, as well as in the extractive industries, the problem is serious. Land *value* often accounts for 15% or more of the total *value* of all tangible resources, but the book figure shown for land (and certified to by the CPA without comment) is often only a fraction of its value.

Understatement and concealment of assets is an old story dating back to the days when hiding valuables from the eyes of the tax collectors was conventional conduct. Most of the works on auditing and accounting over the past half-century continue to cater to understatement, especially by overemphasizing the significance of recorded costs. In most books the reader is warned about the need for vigilance in preventing padding and overstatement, but virtually nothing is said about understatement, which is actually the important problem.

The point of these comments in this connection lies in the undesirability of giving encouragement at this juncture to the understatement of business resources, tangible or intangible. It is the job of accounting to disclose significant financial measurements, not to cover up. Starting from the days when reporting of assets was confined to cash and receivables (in the old "current-account" balance sheet) some progress has been made in broadening disclosure of resources and this is no time to start retreating. We now insist on reporting inventories (although there are always those who want to minimize inventory values), depreciable assets, and at least token figures for natural resources owned. Most accountants, presumably, favor recognizing and amortizing the costs of patent rights and related resources. The continuing serious decline in the value of the dollar adds to the need for the abandonment of the idea that it is a virtue to conceal or understate assets.

Some understatement, especially in a period of soaring prices, is probably inevitable. It may be inexpedient to attempt to include all applicable costs (for example, the costs of buyer's services, and the cost of accounting for purchases) in ascertaining inventory balances. Very likely the practice of currently expensing marketing costs related to future rather than current revenue will be continued. Finding appropriate current values for specialized machinery is always troublesome. It should probably be conceded that the intangible area presents especially difficult problems. But let's not condone—to say nothing of urging—immediate suppression of payments explicitly made for the package of intangible resources inhering in the total worth of an enterprise, and just as valid a part of such worth as any other segment thereof.

(The authors of this study, it may be noted here, oppose the pooling procedure, favor the use of current values in accounting for tangible assets acquired, and reject the carrying forward of the earned surplus of an acquired company, and I agree heartily with their stands on these points.)

Reconciliation of Accounting for Nonpurchased and Purchased Intangibles. The authors of "Accounting for Goodwill" make quite a bit of the idea that their proposal to treat the lump-sum value of intangibles inherent in the value—purchase price—of an entire business as an immediate loss of capital is the route to a solution of the long-standing problem of the relation between intangible value built up by various efforts and factors in the course of operation and intangibles acquired by outright purchase. But they are mistaken in assuming that they are contributing to the solution of this problem.

In the first place the contrast between the two cases is overdrawn. Strictly speaking, intangibles growing out of technological and marketing research and other special efforts of management to improve methods, develop products, and otherwise operate more effectively, are not properly described as "nonpurchased." Instead they are in effect "purchased"—at least in part—by piecemeal expenditures therefor over a period of years. A lump-sum purchase need not be regarded as identical with the result of the piecemeal process, but neither is it an entirely different kind of animal.

Moreover, and more serious, the authors' proposal regarding the lump-sum cases creates a basic conflict rather than solving anything. Research and development costs, patent cost, and all the other costs incurred that may be regarded as contributing to the growth of intangible value, are regularly *charged to revenue as operating costs.* The timing is often questionable, but this is a far cry from regarding these costs as a direct deduction (like an outright loss) from the stockholders' equity. To reconcile the two processes the authors should be recommending that the lump-sum cost of intangibles should be spread over expenses for a period of years, in rough accord with the way in which the costs of developing intangible value within the business are spread by piecemeal incurrence and expensing. Indeed, this would be a very reasonable and acceptable proposal—at least in many cases.

Some Basic Considerations in Accounting for Business Combinations. When two or more companies are merged, or combined in any other way, there are some fundamental considerations that should control.

1. Presumably book values should *not* be carried forward. In view of the limitations of accounting at best, plus persistent inflation, a serious effort should be made to ascertain the current value of each of the entities being combined. The so-called "pooling" approach should seldom if ever be employed.

2. The total value of each enterprise should be classified, carefully, for future accounting purposes. This will ordinarily require the careful valuation of all the tangible resources included. The book figures are presumably acceptable in the case of cash balances, and may not require major amendment in the case of receivables. Market value is of course the only sound basis for recording marketable securities acquired. Outside the monetary asset group, careful determination of current value is needed.

3. The usual view is that intangible value emerges in the classifying process only when the total value of the enterprise acquired or merged exceeds the total value of all tangibles as appraised individually, and in many situations this interpretation may be justified. But subordinating the intangibles in this way may not always be warranted. For example, investigation may disclose in a particular case that earning power and overall value depend to a major degree upon existing patent rights.

4. The portion of total value imputed to intangibles should be broken down into major elements (see previous comments) wherever possible. Only that part of the intangible portion not assignable to a particular factor (for example, patents) should be designated as goodwill.

5. The general presumption is that the segregated goodwill element is an amortizable asset, over a relatively limited period.

When Is an Asset Not an Asset. The authors of this study attempt the impossible. They admit that the total value of an enterprise properly determined may include a payment for intangibles and then they propose to sweep such payment under the rug—the identical treatment that would be justified if it were discovered that through fraud or stupidity the total value set on the enterprise was padded. I don't quite see how such a position can be taken in reporting the transaction to the stockholders who have provided the funds to make the acquisition. It amounts to saying that "we made a careful valuation of the purchased enterprise and believe that the value is sound, but we think it best to treat a portion of your investment as an immediate loss because we don't like the color of a portion of the total value." Of course, it might be proposed that "the object of writing off immediately a portion of a sound total value is to reduce future charges to revenue, and make it possible to apply an overstated net income to an understated total investment in determining the earning rate," but this wouldn't sound well either.

We are confronted here with another attempt to have one's cake and eat it too, and this is a stunt that simply can't be done.

Comments of J. S. Seidman

I dissent from that part of the research study that calls for the immediate charge-off of purchased goodwill, and that the charge-off be against stockholders' equity.

To write off any asset at the time of purchase is inherently wrong. To write it off against stockholders' equity is a throwback to the days when accounting was in its primitive stages.

That purchased goodwill is an asset is demonstrated by the purchase itself. The fact that it is an "intangible" certainly cuts no ice in the accounting treatment. Like electricity, the intangibles may be the generating source of value to the tangibles.

What is purchased goodwill? Essentially, it is the premium payment for a business because of its rate of earnings. It is like paying a premium for a bond because the coupon rate is higher than the going interest rate.

To kick these premiums under the rug by an immediate write-off against capital is an assault on accounting. An illustration—highly oversimplified—will expose the wounds.

Company A starts with a cash capital of $100, and pays that amount for a business earning $6 a year with tangibles worth $100. Company B starts with a cash capital of $150, and pays that amount for a business that has the same $100 of tangibles but earns $9 a year—hence the extra $50 purchase price. Now suppose that the accounting research study prevails, and Company B immediately charges the $50 against its capital.

Here are some questions that must be answered on cross-examination:

(1) Is it rational to say that B starts with a deficit of \$50? How can there possibly be a capital impairment when, for that \$50, B received a quid pro quo?

(2) Is it rational to say that though A puts all its capital into a \$100 purchase and B puts all its capital into a \$150 purchase, they each emerge with the same financial position; namely, assets and equity of \$100? On what theory can the management of B, in its stewardship, be called upon to account for only \$100 when \$150 has been expended?

(3) Is it rational to say that A earns 6% on its investment, and B earns 9% on its investment, when each business was in fact bought on a 6% return?

(4) Putting it another way, since B paid \$50 for the extra \$3 a year earnings, mustn't the \$50 (just like the premium on the bond) be recouped, on some time pattern, in order to arrive at B's true earnings? What happens to the principle of matching cost against revenue when earnings are determined without taking into account the expenditures made to acquire those earnings?

(5) Don't existing or prospective stockholders get off to a false start with earnings figures that ignore, and a balance sheet that buries, the \$50 payment?

(6) Doesn't the \$50 write-off distort factors like amount available for dividends or stock redemption; indenture requirements for total assets, ratio of capital to liabilities, return on investment; stockholder-agreement buyout figures based on equity or book value?

(7) Suppose the business is resold and the sales price brings back part or all of the \$50. Is there a profit? If so, is it to be credited to income though the cost appears as a charge against capital?

(8) Why a write-off of only the \$50 amount? Fixed assets are like goodwill, in the sense of being a prepayment for expected earnings. Why not, on purchase, write off the fixed assets, too?

The implied answers to these questions put a damper on the proposed immediate write-off of purchased goodwill against capital. But many arguments are adduced in the research study to shore up the proposal. They must be dealt with before the proposal can be completely dismissed. Some have already been considered in the foregoing discussion. The others will now be covered, by enumeration.

(1) ***Argument:*** Goodwill is a capital contraction. It is like treasury stock. ***Answer:*** A capital contraction would have to fit into one of these categories—dividend, redemption, gift, liquidation, loss, prior year adjustment. Obviously, purchased goodwill is none of these. The similarity to treasury stock can't survive either. Treasury stock is not the handmaiden of an acquisition of assets but rather the contraction of the number of shares interested in the assets.

(2) ***Argument:*** Analysts and bankers ignore purchased goodwill. ***Answer:*** If this is true, it merely means that analysts and bankers, for their special purposes, have special yardsticks. Credit people are interested in cash flow, and frequently in their calculations ignore deferred charges and many tangibles. Does that mean professional accounting should likewise emasculate these items in determining financial position?

(3) ***Argument:*** The write-off will unify the treatment of purchased goodwill and internally developed goodwill. ***Answer:*** It will do just the opposite. Internally developed goodwill is scattered among the expense accounts and therefore filters through as a deduction in arriving at earnings. Purchased goodwill, under the proposal, never touches earnings but is instead lopped off from capital. It is true that an inconsistency does exist today in the capitalizing of purchased goodwill and the expensing of internally developed goodwill. This stems from the underlying circumstances. Internally developed goodwill cannot be identified or measured within the vast number of expenses and policies, the cumulative effect of which creates the goodwill, and so the entire amount is expensed. With purchased goodwill there is specific identification and measurement in an arm's-length trans-

action. This is no different from the inconsistency in the handling of research and development. Internally developed research and development is generally expensed though some of the amount results in very valuable patents. Had those same patents been bought, instead of internally developed, the purchase price would have been capitalized.

(4) *Argument:* It is difficult to determine the amortization period for purchased goodwill. ***Answer:*** Agreed. But burying goodwill alive is a rather extreme way out of the difficulty. Measuring the depreciation period is difficult, too. That is hardly justification for putting the death knell to depreciation accounting. Informed judgment is all that good accounting calls for in arriving at the depreciation period. The same equally applies to the amortization period of purchased goodwill. If that informed judgment carries to the conclusion that the purchased goodwill can be considered perpetually enduring, there is nothing to amortize, just as in the case of any other perpetual asset. That, however, is a far cry from writing off the asset on purchase. To the contrary, it supports the view that at no time is a write-off justified.

Semantics may be one of the things that becloud this accounting problem. The word goodwill, even when purchased, brings a hangover image from the days when goodwill was regarded as a way to "water" stock, or to puff, or to try to make something out of nothing. Some other, and more accurate, label is in order. I suggest the following be considered:

(a) excess of purchase price of business over value of tangible assets

(b) premium paid for anticipated above-normal earnings

(c) prepayment for certain anticipated level of earnings.

To conclude: Purchased goodwill should be treated like any other purchased asset. Purchased goodwill is nothing to be ashamed of. It should not be hidden or obliterated. An immediate write-off, aggravated by a write-off against capital, must not be countenanced.

Comments of Leonard Spacek

This research study represents a significant contribution to accounting thought. The implementation of the conclusions of this study would result in great benefit to investors by improving accounting for business combinations. No accounting problem is more urgently in need of a solution than this one, and any further delay in coming to grips with it would continue the present misleading financial reporting to investors, to creditors and to the public.

The long-term controversy and confusion which have existed in accounting for business combinations and goodwill reflect two shortcomings of accountants in arriving at solutions to accounting problems, namely (a) a failure to define clearly the objectives of financial statements, and (b) an apparent reluctance to examine critically the nature of the values to be accounted for in business enterprises. These shortcomings become particularly vivid when one business acquires another, where accountants must consider an exchange of enterprise values and provide a meaningful accounting basis for the assets and liabilities of the continuing business. Present practice is based on ivory tower theory. That theory results from premises that never have existed and never will exist; and, therefore, the theory is at odds with reality, usefulness and honesty.

It is regrettable that a research effort such as this must be undertaken in an environment in which basic objectives and standards are unclear and ill-defined. In the absence of such standards, it was necessary for the authors of this study to give consideration to defining certain financial statement objectives and uses, as a basis on which to seek a solution to the problem of accounting for purchased goodwill. I expect, therefore, that this research study will be subject to substantial criticism since the authors and the readers of the study will undoubtedly have a divergence of views on financial statement objectives. But, this is the price of progress in an area dominated by a dogma that is contrary to reality and forthright communications.

The study states that a fundamental objective in accounting is to achieve a fair presentation of financial information in a manner most useful to investors, creditors and other segments of the public. Financial statements have a much broader purpose than presenting financial information to managers or proprietors, all of whom may have ready access to a wide variety of detailed data on a business enterprise. The investor and creditor rely heavily on the accounting profession for dependable, useful financial information for their decisions. Solutions to accounting problems must always be sought in the light of this use.

From this study the real nature of goodwill emerges. It is the stock valuation placed on the prospects of a business as a whole in excess of the fair value of its net separable resources and property rights. As a stock valuation it embraces the speculations, the depression, the optimism of the composite and individual investor viewpoints, plus the public state of mind, on every conceivable subject from birth rates to war. Goodwill is not a value consumed in the production of profits. It doesn't wear out; it can grow instantly or cease to exist instantly—sometimes in the opposite direction from present profits. Its value is not a result of costs incurred, because goodwill is an amount established by investors in evaluating a present going business, and that business's future prospects—or of a new business undertaking and its prospects before development costs are incurred.

Goodwill is enhanced by increased market prices of securities and depressed by decreases in the same prices, because goodwill is the progeny of such prices, whether the medium of exchange is cash or securities. Consequently, the value of goodwill increases with improvements in general prosperity, prospects of increased profit, favorable international balance of payments, peace conferences or prospects of peace, lower taxes, increased productivity, price increases, overheated economy, speculation, avoidance of strikes, the vagaries of pooling of interests accounting, etc., etc. Likewise, the value of goodwill decreases because of threat of or actual labor strikes, rumors of war involving our country or other countries, imbalance of international payments, higher taxes, discontent and riots, higher interest costs, lower production, cloudy business prospects, fear, conservatism, cynicism, etc., etc. Goodwill values are created from all of these conditions or none of them, depending upon when a valuation takes place and the state of mind of the public investor, the institutional investor, the analyst, the economist, or anyone else who makes or influences stock market decisions. Goodwill is continually buffeted and reconstituted with changes in the mixture of the ingredients and it is as fluid as the outlook on every conceivable condition of the future. Goodwill is so much the result of all of these values that it is in fact these values. These many conditions do not have lives. These conditions exist or cease to exist in varying degrees and none of them can be accounted for in financial statements; they will always be readers' values that are closely related to the fickleness, firmness, and contrariness of the investors' minds as they see or think they see future conditions, whether such conditions are true, imagined or false.

Goodwill is not an asset that can be presented in a balance sheet like cash, receivables, inventories, investments, plant, accounts payable, and debts—these are closely related to dollar valuations measured against actual or estimated items that carry over from one day to the next during their lives and are always rooted to their origin until they are in one way or another disposed of in the stream of profit or loss from operations. Not so with goodwill value which is the child from the marriage of the current net income with the investors' state of mind. Accounting for goodwill cannot be based on a butterfly net and display the one species that happens to be caught as of a moment as a fair representation of all, when the species change faster than they could be caught, even if they could all be caught.

The study recognizes that goodwill attaches to the business as a whole and that the investor—the marketplace—determines the value of goodwill for a business. Accountants do not create values; and it is not their job to "second guess" market prices. The problem is one of establishing proper accountability for the values established in an exchange of one business for another, or in a combination of businesses. One fact which is frequently overlooked is that the value of the goodwill of one or both of the enterprises in a business combination may be significantly affected by the combination itself. In other words, the total value of the enterprises separately may not be the same as their values on a combined basis.

Financial statements should provide some of the information necessary for the innumerable considerations that go into the public investors' minds where the value of the business is established for a particular moment and, hence, the value of its goodwill. Inclusion of any part of that goodwill value in financial statements which investors use in determining the value of the business at a particular time is recording value that has only momentary life after which it will be replaced by another investor evaluation based on changed conditions. Recording an amount for goodwill requires its elimination by the reader of financial statements in order to make an up-to-date valuation of goodwill. Therefore, a determination at any time is immediately obsolete. Regardless of how anyone may think goodwill should be valued, the fact is that goodwill is derived by making deductions for other assets from the market valuation of the overall business. Goodwill value is like the weather—whatever it is becomes a fact of history a moment later when it changes.

The tendency of accountants to accept the theoretical viewpoint that purchased goodwill is "just like any other asset" and their failure to recognize the special inseparable nature of goodwill as related to the business as a whole have been at the heart of our problem in accounting for goodwill.

The traditional capitalization-amortization approach to purchased goodwill which some accountants continue to advocate as a required part of the cost basis of accounting is based on erroneous assumptions as to the nature of goodwill and the real purpose of financial statements today. That approach, if it is to be rational and not arbitrary, must assume that purchased goodwill is measurable as a separate element of the total goodwill of the entire business, that goodwill has characteristics which render it definable in terms of a limited or unlimited term of existence, and that goodwill is consumed in the production of profits. These assumptions are totally inconsistent with the characteristics of goodwill, as identified by this study. Attempts to liken goodwill to other assets for accounting purposes are doomed to failure because goodwill lacks any continuity within itself and its value is not compiled by dollar determinations as are other assets, liabilities, revenues and expenses which are usually recorded. The basic concept that must govern the accounting for goodwill is that it is not an asset that can be reflected in financial statements because it is based on an "opinion value" continually redetermined by investors.

No part of "stockholders' equity" in a balance sheet should exist by reason of goodwill value shown as an asset and determined at some past date for an undefined segment of the total business. The value of the goodwill of such a segment is not determinable at the later balance sheet date separately from the goodwill of the entire enterprise. Goodwill value of the entire enterprise at a date preceding the balance sheet date is not a useful or fair reflection of anything in the financial statements, since the same financial statements are continually used to reevaluate the business, and thus its goodwill, at later dates. Consequently, the inclusion of any or all of a company's goodwill value in a balance sheet at any time is a misleading and confusing obstacle to the reader, and, therefore, not a fair presentation of the facts.

The capitalization requirement in accounting for purchased goodwill in business combinations led businessmen and accountants to the make-believe world of pooling of interests, in an attempt to by-pass and circumvent the cost theory of accounting and achieve a more reasonable accounting for goodwill. However, pooling of interests accounting, far from solving the problem, has created chaos and has so obscured the facts involved in business combinations that even the most expert financial analyst must be unable to distinguish reality from illusion.

Pooling of interests is based on the unrealistic premise that when stock is exchanged in a business combination no purchase takes place, but that a purchase does occur when cash is used. In no other business transaction does the mode of consideration determine the type of transaction that took place. In every other transaction the "consideration" whether in cash, notes, stock, or other property, is accounted for at its current value. An exception was created for combinations by inventing the pooling of interests concept whereby the value of the consideration given is not accounted for. In this manner, the need to remove goodwill from the balance sheet was accomplished without having to acknowledge explicitly that goodwill was not a balance sheet asset.

The obvious interchangeability of cash and stock quickly penetrated this facade. Businessmen and accountants, in order to be realistic, properly contrived to camouflage cash transactions as stock deals by various devices such as by using treasury stock as an exchange vehicle, by the "downstream" merger technique discussed in the study, or by issuing low-par, high-redemption value preferred stock. As a result, business combinations which are in substance effected by cash are being accounted for as poolings of interests to achieve the more realistic result of not recording goodwill.

Under the pooling of interests method, accountants must disregard the values of producing assets being exchanged—values which are the accepted basis of accounting for all other arm's-length business transactions. This is the method which truly sweeps all values paid for under the rug. The solution proposed in this study merely recognizes the facts and makes an honest accounting of each of them.

By not accounting for values exchanged, businesses can, in effect, report proceeds from the issuance of capital stock as earnings. This result is dramatically illustrated whenever stock is issued in a pooling of interests for a company with tangible resources whose current values exceed book value. Accounting for the acquired resources at prior owners' cost after the business combination can result in significant showings of profits for the continuing entity—which represent proceeds of a stock issue. The sale of capital stock and the credit of the proceeds to profits would be abhorrent; yet, the pooling of interests is the accounting cosmetic that makes such results acceptable.

The pretense in pooling of interests that, after a business combination occurs, the constituents should be regarded as always having "been together" and that their historical financial statements therefore should be combined for all prior periods, also leads to some illogical results. The effect of pooling of interests sets into motion no end of illusory appearances. For example, a company may buy another business near the end of its fiscal year or even after the end of the year and add the earnings of the acquired business to its own earnings for the entire year. Making the actual accomplishments of management as elusive as the marble in a shell game does not provide honest communication to investors. The problems involved in trying to retroactively reflect current corporate capitalizations to match earnings added retroactively for computing earnings per share and other purposes dramatize how fictional the whole procedure is. These results have been accepted to achieve an honest elimination of goodwill from the balance sheet.

The conclusions of this study can lead us out of our current dilemma. Elimination of pooling of interests accounting would result in one basic approach to accounting for most business combinations and in treating the transactions for what they really are—purchases of one business by another. Under purchase accounting the continuing enterprise would carry in its balance sheet the fair values of the resources and property rights acquired in a manner comparable to the accounting followed in other types of business expansion.

By deducting amounts paid for goodwill from stockholders' equity, purchased goodwill would be accounted for in a fashion consistent with its characteristics, and as achieved by pooling, but without distorting the accounting for all other assets acquired in the same transaction. Goodwill value would not be allowed to affect the determination of financial position or of earnings in the future, and investor decisions on enterprise values would be based on accounting information independent of that investor opinion on overall investment value.

The misleading implications of growth which now result from restatements to combine the earnings of constituents under pooling of interests when compared with earnings trends reported under other conditions of business expansion would be eliminated in future financial reports. Historical earnings summaries would no longer be distorted by mixtures of poolings and purchases, sometimes in the same transaction. One consistent, logical, practical method of presenting earnings trends for all kinds of business combinations and expansion would result. All values exchanged in a business combination would be fully and honestly accounted for.

The conclusions in this study make accounting and business sense; they are in accord with objectives of financial reporting and are consistent with the broad conventions currently used to meet those objectives. Many of those who challenge the treatment of goodwill recommended in this study, and at the same time deplore pooling of interests accounting, have come up with no useful alternative solution. We cannot keep investors indefinitely mesmerized with the accountants' unrealistic theories and indecision on this rather simple point. It's time to settle this problem and go on to other problems. The Accounting Principles Board should issue a pronouncement on accounting for business combinations and goodwill as soon as possible, and I recommend that it adopt the conclusions of this study.

Comments by Director of Accounting Research

Several members of the project advisory committee have criticized various parts of the arguments leading to the solutions proposed by the authors of this study. In commenting on the substance of the study I would make many of the same points. I believe, however, that the primary obligation of the Director of Accounting Research is to comment on the research approach rather than on the validity of the arguments and conclusions in the study.

Accounting research studies are part of the program of the American Institute of Certified Public Accountants to determine appropriate accounting practice and to narrow the areas of difference and inconsistency in practice. Accounting research studies are intended to provide an adequate basis for informed discussion of important accounting problems and to aid the Accounting Principles Board in evaluating alternative solutions. To fulfill those functions, a study should clearly define the problem or problems to be considered, identify the possible solutions, and evaluate them in the light of both theoretical and practical considerations. If the approach in a study is theoretical, its premises should be identified specifically and the reasoning which leads from premises to conclusions should be set forth clearly. Unless the study contains an identifiable "trail" of the reasoning, readers cannot appraise the authors' work and cannot use the study to evaluate the alternatives.

In my opinion, this study is not as informative as it should be and does not serve as an adequate basis for evaluating possible alternative methods of dealing with the problems of accounting for goodwill and business combinations. My criticisms in these comments are discussed under three headings: (1) balance, (2) frame of reference, and (3) trail of reasoning.

Balance

Authors of an accounting research study are expected to indicate the solution or solutions to accounting problems which they prefer and to give reasons for their choices, but a study should not be turned into a tract or brief. The role of advocate should be secondary to the role of evaluator.

In this study, the authors are primarily advocates. They do not present a balanced evaluation of the pros and cons of alternative courses but tend to stress the strengths of the alternatives which they prefer to the almost complete exclusion of the weaknesses and tend either to ignore other alternatives or to stress the weaknesses. As an illustration, the authors say that charging purchased goodwill to stockholders' equity at the time of combination makes balance sheet and income statement reporting for "purchased" goodwill consistent in principle with accounting for "nonpurchased" goodwill (page 106). They barely acknowledge, however, that the cost of "nonpurchased" goodwill is charged to income while the cost of "purchased" goodwill under their solution is never included in income.

The tendency to ignore alternatives, or at least their merits, is illustrated by the oversimplification of complex issues. For example, the purchase-pooling question in accounting for business combinations is made "black and white" by setting it out as the choice between (1) recording all combinations, except those in which a "new" enterprise results, as purchases or (2) recording as purchases those combinations in which the consideration is cash or other assets and recording as poolings of interests those in which the consideration is shares of stock of one of the constituents. The choice is then made to depend on whether consideration of stock is in substance the same as or different from consideration of cash or other assets. Other possible approaches are not evaluated, and the concept of a "pooling" or "marriage" of interests is not examined. The study says that the criteria for distinguishing between a purchase and pooling of interests in *Accounting Research Bulletin No. 48* are ineffective and have resulted in degeneration of practice but does not analyze what may be wrong with them or whether they can or should be saved or replaced.

Similarly, after the conclusion that nearly all combinations should be recorded as purchases, accounting for goodwill is treated on the same "either-or" basis. Most of that portion of the study is devoted to discrediting current practice. The authors' solution is then proposed as *an* alternative to present practice. Other alternatives—such as charging goodwill to earnings of the period of acquisition—are not set forth and evaluated. The implication in the presentation that the authors' solution is the sole acceptable way because present practice is unacceptable does not necessarily follow.

Frame of Reference

Accounting may be analyzed theoretically on at least two levels: (a) within the context of accounting based primarily on the matching of expired acquisition costs with realized revenue, a theoretical structure which is currently accepted and is often called "historical-cost" accounting, or (b) outside that context. Staying within historical-cost accounting allows certain premises to be asserted without proof or evidence because they are already widely accepted and their merits have been discussed and debated in accounting literature for many years, but the boundaries and characteristics of that frame of reference must be accepted. Going outside the historical-cost framework presents fewer restrictions, but the validity of many or most premises must be demonstrated.

The authors claim to stay within the accepted historical-cost basis of accounting in this study (page 22). Yet they depend on premises which are outside it without establishing their validity. They assert, for example, that the "function of the balance sheet is to report, subject to the limitations of the cost basis, the values of the *separable*

resources and property rights of the business committed to the production of earnings in the future" (page 81, emphasis added). Another premise of the same type is explicitly borrowed from the work of Professor Raymond J. Chambers: "... goodwill is an asset of the owners of a business entity rather than of the business entity itself" (page 19). The point I raise is not whether the premises are good or bad but that they are from outside the system which the authors purport to follow. These premises are set forth in the study without support—Chambers' arguments, which are quoted, do not constitute support in this context because he is working within another system which is explicitly *not* based on historical cost. Making the statements premises in the study amounts to assuming away the problem of whether goodwill should appear as an asset in the balance sheet of an enterprise.

On the other hand, the study makes no use of some premises or propositions which are part of the historical-cost frame of reference. For example, the essential similarity of expenditures for tangible and intangible assets under historical-cost theory is not discussed (a point which is, however, adequately covered in Professor Paton's Comments on pages 143 to 151).

Trail of Reasoning

The reasoning in this study is difficult to follow because the authors have not left a clear trail. Ideas are introduced, sometimes with and sometimes without support, and then ostensibly are dropped. Often they reappear, frequently still unsupported, as the reason for some conclusion. Thus, one of the "distinguishing characteristics" of goodwill is described in Chapter 2 as: "Goodwill is not utilized or consumed in the production of earnings" (page 21). This statement is not explained or developed in the study but appears in Chapter 8 to show that goodwill "cannot reasonably be evaluated in terms of either an unlimited life or a measurable estimated limited life." The reasoning contains a gap; assertion of the premise is equivalent to assertion of the conclusion.

Some comments and ideas raised do not seem to be used in the argument at all. For instance, one of the criteria or guides based on the authors' "financial statement objectives and accounting conventions" in Chapter 3 is "Current Values of Resources (Assets)—Important Information" (page 35). This criterion or guide conflicts with another, namely conforming to the historical-cost frame of reference (no. 6, pages 35 to 36), but its major feature is that it is superfluous. As far as I can tell from the reasoning presented, the criterion plays no part in any significant conclusion in the study—it merely distracts from essential points and obscures the trail of reasoning.

Perhaps the handling of abstract concepts is the most influential factor in obscuring the trail of reasoning in the study. To avoid confusion, abstract concepts should be clearly identified and different concepts should be given different names or labels. One major cause of difficulty in following the trail of reasoning in the study is that the word "goodwill" is used to apply to a number of different concepts. For example, much, perhaps most, of the discussion of "goodwill" is in terms of valuation aspects, in fact in terms of measures of value. "Goodwill" is often described as the difference between the fair value of the company's stock (i.e., the market price of a share multiplied by the number of shares outstanding) and the fair value of its "separable resources and property rights." A body of conclusions is developed from these value notions. Then, however, those conclusions derived from *measures* of the *value* of "goodwill" are transferred to the *cost* of "goodwill" without considering the essential difference in concept under historical-cost accounting of amounts entered in the accounting records as a result of valuation procedures and those entered as a result of expenditures of resources. Shifting between concepts is most clearly evident in Chapter 6, in which the discussion of "non-purchased goodwill" is given in the form of an answer to two questions (page 68): "Should a company capitalize the total market price of its outstanding stock, thereby recording its entire goodwill value as an asset? And, should the goodwill then be amortized to income, especially if its value diminishes?" The study argues that capitalization of the value of "goodwill" followed by its amortization to income is fallacious and circular. Indeed it is. But the discussion is confused because it involves two different concepts of "goodwill." "Capitalization" (as the authors use the term in Chapter 6) is a valuation process and is unrelated to expenditures of resources. Amortization, in contrast, is the consequence of expenditures—it is the allocation to time periods of a previously incurred cost. Specifying concepts carefully would have avoided the confusion and enabled readers to trace the reasoning to see whether the conclusions about the *value* of "goodwill" are in fact transferable to the *cost* of "goodwill."

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These brief comments are intended to be illustrative rather than comprehensive; they indicate the kinds of deficiencies I find in the work as an accounting research study. Although I have criticized the study, I approve its publication with the comments of the members of the project advisory committee for the reasons given in the Director's Statement (pages xi to xiii).

Reed K. Storey

APPENDIX A

Comments Relating to AICPA Accounting Research Study No. 5

The study on accounting for goodwill is a continuation of *Accounting Research Study No. 5* (*ARS 5*), "A Critical Study of Accounting for Business Combinations" by Arthur R. Wyatt, published by the Director of Accounting Research of the American Institute of Certified Public Accountants in June 1963.

ARS 5 is devoted principally to business combinations resulting from exchanges of equity securities. In accordance with the AICPA's original announcement in 1960, the study gives particular attention to the pooling of interests method of accounting for combinations. This appendix summarizes the results, conclusions, and recommendations of *ARS 5* to relate them to the matters covered in this study.

ARS 5 traces the characteristics of the business combination movement in the United States and discusses the factors which have motivated combinations. The study points out that business combinations in recent years are distinguishable from those of earlier periods in that (a) they have generally not involved two major corporations but rather have involved companies of disproportionate size or companies of relatively similar size neither of which has been dominant in an industry; (b) they have more often been initiated by managements than by investment bankers and consequently management motivations have probably been more important factors than in earlier periods; (c) needs for additional capital, managerial talent, and research activities to keep pace with rapid technological innovations have been an important influence; and (d) income and estate taxes have acted as relatively greater stimuli to combine.

The study traces the development of practices in accounting for business combinations, particularly the developments since World War II and the impact of AICPA pronouncements on accounting practices. It contains an extensive discussion of the pooling of interests concept, tracing its development from its origin to its general acceptance by 1960 as an alternative to purchase accounting in substantially all business combinations effected by stock.

Business Combinations as Exchange Transactions

After tracing the history of business combinations in this country and of the accounting for them, *ARS 5* examines the problem, particularly from the standpoint of whether both pooling of interests accounting and purchase accounting are acceptable.

Accounting deals primarily with business transactions and until a transaction occurs accountants generally find it difficult to reflect the effects of economic activity. "In broad terms a business transaction may be said to involve an exchange of properties and/or equities between two or more independent parties. While business transactions may take many forms, the exchange feature of the transaction is generally crucial for accountants."[1]

The study makes the further point that economic activities are carried on through specific business units or entities and that the results of the accounting process are expressed in terms of those entities. Identification of the entity of accountability in a business combination is important in determining the proper accounting.

An analysis of the nature of a business combination shows that a business combination is essentially a particular type of business transaction, since, regardless of the form, a combination occurs "when one company acquires, assumes, or otherwise gains control over the assets or properties of another company by an exchange of assets or equities, or when two companies of equal size merge to form a new enterprise."[2]

Another conclusion is that a business combination is "an economic event of some import," regardless of the form. That conclusion apparently leads Wyatt to doubt the conceptual soundness of pooling of interests accounting for business combinations involving independent parties.

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[1] Arthur R. Wyatt, *Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations," 1963, p. 68.

[2] *Ibid.*, p. 69.

When business combinations involve primarily an exchange of cash or assets, accountants agree that a transaction has occurred which requires an accounting for the assets received at the fair value of the consideration given or at the fair value of the assets received whichever is more clearly determinable. However, they disagree on the disposition of amounts assigned to goodwill in the combination.

No similar agreement exists with respect to business combinations involving an exchange of common or voting stock. Many businessmen contend that combinations effected by stock differ in nature from those effected by cash. The arguments as to whether pooling of interests or purchase accounting is appropriate center now on this specific issue. *ARS 5* and our study disclose that most of the other criteria listed in *ARB 48* for distinguishing pooling of interests and purchases are generally no longer considered meaningful or useful.

ARS 5 states that those who favor pooling of interests accounting for a combination effected through an exchange of common stock "are convinced that no exchange transaction, in the normal sense of that term, has taken place, and that the accounting for the combination need not follow the pattern used to account for exchange transactions."[3] The proponents of pooling of interests accounting point out that the assets are not changed in substance and that the ownership interests of the two or more companies existing prior to the combination continue in the surviving entity. Their conclusion, therefore, is that the combined entity should follow as closely as possible the bases of accountability which the constituents maintained. The combination should not, the proponents of pooling of interests say, be accounted for as an exchange of assets between companies since no exchange of substance occurs.

Those who favor purchase accounting, on the other hand, are convinced that an exchange transaction occurs when a combination is accomplished through an exchange of common stock and the combination is essentially the same as other exchange transactions. Proponents of purchase accounting contend that the assets acquired enter a new accounting and legal entity (an entity which formerly had no direct financial interest in the assets), that the unissued shares of stock used to effect the exchange are substitutes for cash or other assets, and that the manner in which the combination is accomplished should not

[3] *Ibid.*, pp. 71-72.

affect substantively the accounting. They conclude, therefore, that combinations effected through exchange of common stock are exchanges of assets and the assets acquired should be accounted for on the basis of the consideration given or the fair value of the assets acquired, whichever is more clearly identifiable.

ARS 5 states that the weight of logic and consistency supports the conclusion that business combinations between independent entities are exchange transactions involving a transfer of assets and that the accounting appropriate for an exchange transaction is necessary to reflect properly the results of the business transaction.[4] The conclusion is considered applicable to business combinations effected through an exchange of common stock as well as those accomplished with cash. The following is pointed out:

> Accounting actions are not commonly made in terms of a group of ownership interests, but more commonly in terms of groups of economic assets or properties which a given ownership group may control. When an entity gains control over economic assets not formerly controlled by it, an accounting action is required. When the constituents of the ownership group change periodically, as they commonly do, and when this change results in little or no effect on the assets and properties in use, little or no accounting action is necessary to give effect to the change. When, however, the constituents of the ownership group change and the economic assets which the entity controls also change in a single transaction, some accounting action is necessary to give effect to the new assets which the entity controls.
>
> In a business combination effected through an exchange of stock, two things happen: (1) the assets and liabilities of the entity are expanded, and (2) the ownership interests in the entity are expanded. If the transaction has resulted from arm's-length bargaining between independent parties, the entities involved should give effect to the transaction in a manner consistent with the treatment accorded other transactions in which the economic assets of an entity change.[5]

Conclusions and Recommendations

The essence of the conclusions in *ARS 5* is that substantially all business combinations today are exchange transactions between independent parties, involving companies of disproportionate size with a rather clearly discernible continuing entity. Thus, the study maintains

[4] Arthur R. Wyatt, *Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations," 1963, p. 73.

[5] *Ibid.*, pp. 72-73.

that those exchange transactions should be accounted for as purchases. Under the purchase concept, the assets acquired should be accounted for at cost—the fair value of the consideration given, unless the fair value of the assets received is more clearly determinable as a measure of the consideration. The earned surplus of the resultant entity should be limited to the earned surplus of the acquiring company prior to the transaction plus subsequent earnings of the resultant entity.

ARS 5 states that any portion of the excess of the fair value of the total consideration given in the exchange which is attributable to goodwill should be (a) amortized over the period of expected limited life or (b) if the goodwill does not appear to have limited life, it should be carried forward to future periods until evidence exists that the value is impaired. Thus, the study presumably eliminates the existing alternative practices which permit a write-off to income of goodwill not deemed to have a limited life. No mention is made of partial or total write-off of goodwill to earned surplus which existing practice at the time of the study considered acceptable under certain conditions so long as a write-off was not made at the time of the combination. The recommendations of *ARS 5* with respect to goodwill should be viewed in the context that the characteristics of goodwill and the accounting for it were outside the general scope of that study.

ARS 5 suggests that it would be desirable to restrict the existing pooling of interests method to business combinations in which "no substantive changes occur." This apparently refers to those business combinations involving legal entities associated through common ownership or otherwise related—combinations which do not involve independent parties.

ARS 5 supports the view that in a relatively few combinations no one of the constituents is, in fact, a continuing entity. A new enterprise emerges, requiring a complete new basis of accountability for the assets of all of the constituents of the combination. *ARS 5* recommends that, for a combination of this nature, all of the assets of the resultant enterprise be carried at their fair values at the date of the combination and the resultant enterprise ordinarily should commence operations with no earned surplus. Wyatt refers to the method as "fair-value pooling," and he envisions that its applicability would be limited.

Viewpoints of Others

Members of the project advisory committee for *ARS 5* disagreed substantially with the conclusions of the study. They particularly disagreed with the conclusion that most business combinations effected through exchanges of common stock (with ownership interests in the constituent companies continuing proportionately in the resultant company) represent exchanges of assets to be accounted for as purchases.

Maurice Moonitz, the AICPA's Director of Accounting Research at the time of publication, generally shared the dissenting views of the committee. He considered that the conclusions in *ARS 5* flowed from an assumption regarding the entity for which an accounting is being made. Moonitz suggested that, if a business combination were defined as occurring "when two or more companies merge their assets and place them under common ownership or control by any one of a variety of methods," the conclusions as to the proper accounting might be different.[6] The Director's Preface indicates that the disagreement led to presenting an alternative view, "Another Look at Business Combinations" by Robert C. Holsen, as an addendum to the study.

Holsen distinguishes two basic types of business combinations: (1) combinations in which one group of owners gives up its ownership interests, and (2) combinations in which both (or all) groups of owners continue as owners in the resultant company. Holsen considers the latter type a pooling, which he describes as a situation in which "one company does not acquire the assets or control of another; rather the shareholders who controlled one company join with the shareholders who controlled the other company to form the combined group of shareholders who control the combined companies."[7]

Holsen then draws the following conclusions:

1. A purchase occurs when consideration other than equity shares is exchanged and one group of shareholders gives up its ownership interest in the assets it formerly controlled.
2. A pooling of interests occurs when equity shares are exchanged and both groups of shareholders continue their ownership interests in the combined companies.
3. As Arthur Wyatt has demonstrated, criteria such as relative size and continuity of management, as set forth in *Accounting Research Bulletin No. 48*, cannot be supported by logic; certainly they have not been followed in practice.[8]

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[6] Arthur R. Wyatt, *Accounting Research Study No. 5*, "A Critical Study of Accounting for Business Combinations," 1963, Director's Preface, p. xii.

[7] *Ibid.*, p. 110.

[8] *Ibid.*, p. 110.

Holsen envisions an exchange of shares for purposes of a pooling of interests as an exchange of unissued shares of common stock of one company for all of the outstanding shares of common stock of another. He discusses various deviations from this purest form of exchange and their consequences on the propriety of treating a business combination as a pooling and generally concludes:

1. If cash is also used in the exchange but the amount "is not material in relation to the transaction," the combination should be considered to be a pooling of interests.
2. The pooling of interests treatment should not be allowed when preferred stock of one entity is issued for the common stock of another, unless the preferred stock is convertible and basically is "a substitute for common stock."
3. The use of treasury stock "raises questions" and the answer to the proper accounting "hinges on motivation and intent, which are not subject to objective determination."
4. The propriety of treating a combination as a pooling of interests when minority interests emerge in a combination should not be questioned if that interest is "not material in relation to the subsidiary company."

Holsen also discusses the key issue in the problem of accounting for business combinations—the treatment of goodwill. He quotes from an article by Homer Kripke in *The Banking Law Journal* of December 1961: "the loss of goodwill as a balance sheet asset is deemed of no importance, because accountants and financial analysts have come to regard such intangibles with suspicion and to automatically disregard them in computing net worth." Holsen points out that if goodwill is amortized by charges to income, the period of amortization is usually arbitrary and does not bear a relationship to "any demonstrable diminution" in value. Holsen suggests that existing practices of accounting for goodwill should be reexamined and "consideration given to allowing a company to charge to earned surplus the amount of goodwill at the date of its acquisition."

A review of the letters received by the AICPA commenting on *ARS* 5 discloses a variety of views. The general tone indicates agreement that (1) the study is a thoughtful and thorough analysis of the problem, (2) accounting practices in the area of business combinations have deteriorated in recent years, and (3) improvements and new guides are needed. However, many of the letters express substantial disagreement with the conclusions in *ARS 5*.

Some object to the principal conclusion that substantially all current business combinations are exchange transactions between independent parties, involving a transfer of assets, and that the accounting for those combinations, therefore, requires purchase accounting. Those commenting generally consider that both pooling of interests and purchase accounting are appropriate methods and the problem is to establish a proper basis for identifying the circumstances when each is appropriate.

Several writers seem to agree with the conclusions expressed by Holsen in the addendum, conclusions in which Moonitz and the members of the project advisory committee apparently concurred in most respects. A typical letter expressing this view states: "If, in fact, substantially the same group of owners of two companies end up owning a share in the combined company, why should their earnings and dividend position be affected by an accounting treatment which caused the assets of one of the companies to be revalued."[9] In effect, the writers suggest, as did Holsen, that when common shares are exchanged, no exchange transaction occurs which affects the business entities themselves but the ownership interests are simply combined, which requires no new basis of accountability. This is the critical issue which must be resolved in deciding whether there is a proper place for both pooling of interests and purchase accounting for business combinations.

A substantial number of those commenting on the study stress the need for a study of accounting for goodwill. A typical comment is:

> From my reading of the Study, the treatment of goodwill in a combination defined as a purchase emerges as the crux of the problem. An unwillingness on the part of management to be bound by the provisions of ARB No. 43, Chapter 5, has apparently resulted in an erosion of the criteria established in ARB No. 48, to the end that almost any combination can, without regard to the time element, be justified as a pooling of interests.
>
> It would, therefore, seem that goodwill should be made the subject of an intensive inquiry, prior to any attempt to adopt officially Dr. Wyatt's recommendations.[10]

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[9] Memorandum attached to letter of American Petroleum Institute, November 12, 1963.

[10] E. W. Smith, School of Business and Economics, University of Delaware, September 30, 1963.

APPENDIX B

Comments Relating to Accounting for Business Combinations by Committee of American Accounting Association

The report of a committee* of the American Accounting Association in *A Statement of Basic Accounting Theory* (1966) included (page 33):

> *Purchase and pooling.* Although market transactions resulting in combinations or reorganizations of business entities are recorded, there is considerable freedom in recording such transactions as either a pooling of interests (where the market transaction is treated as if it created no *new* exchange values for the assets involved) or as a purchase (where new exchange values resulting from the market transaction are recognized). This is perhaps the classic case of quantifiability and verifiability warring with relevance. It is true that carrying forward the existing book values of the two combining entities is eminently quantifiable since the figures exist on the books. It is more than questionable that such a treatment, which essentially ignores the new exchange values created by a significant market transaction such as the combination of two companies, can be said to be relevant for investment decisions. When a single machine is purchased, the book value of that machine on the seller's books is considered irrelevant for the purchaser's records. The same is true when a company is merged or purchased. The committee feels that in most instances in such a transaction enough evidence exists to provide verifiability and freedom from bias, and that relevant exchange values resulting from such transactions should be recognized, and thus recommends that the pooling of interest technique be disallowed.

* Committee to Prepare a Statement of Basic Accounting Theory—Norton M. Bedford; R. Lee Brummet; Neil C. Churchill; Paul E. Fertig; Russell H. Morrison; Roland F. Salmonson; George H. Sorter; Lawrence L. Vance; and Charles T. Zlatkovich, Chairman.

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