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THE EVOLUTION OF APB OPINION NO. 17 *ACCOUNTING FOR INTANGIBLE ASSETS;* A STUDY OF THE U.S. POSITION ON ACCOUNTING FOR GOODWILL

Abstract: The paper traces the development of the current valuation concept of goodwill from 1900 to 1970, when the present position was articulated. The paper suggests that there may be alternative bases for goodwill valuation and concludes that additional research is needed on the subject.

One of the most delicate and difficult problems in accounting today is the valuation of goodwill. The profession's current position on this subject is contained in Accounting Principles Board Opinion No. 17[1] which concludes that (a) only the cost of intangible assets, including goodwill, acquired from other enterprises or individuals should be recorded on the books, (b) the amount paid represents the proper valuation basis for the goodwill (i.e., the traditional historic cost principle is applicable), and (c) goodwill, once recorded on the books, should be amortized systematically to income over a period not to exceed forty years.

The purpose of this paper is to trace the development of this position in the United States from 1900 to 1970. Such a historical review suggests that, in the past, although we have tried and rejected various alternative concepts of goodwill valuation, there may be alternative valuation bases for goodwill which will make today's financial statements containing goodwill more meaningful.

The organization of the paper partitions the time period 1900 to 1970, into four periods, as follows:

1900 to 1932
1932 to 1944
1944 to 1957
1957 to 1970.

The reason for this partitioning is that (a) 1932 represents the date of entry of the American Institute of Accountants (now, American

Institute of Certified Public Accountants) into the accounting standard setting arena; (b) Accounting Research Bulletin No. 24[2] was issued in 1944; (c) Accounting Research Bulletin No. 48[3] was issued in 1957; and (d) Accounting Principles Board Opinion No. 17[4] was issued in 1970, reflecting the current position on the subject. These events represent major changes in viewing goodwill valuation and so make convenient punctuation marks for this review.

In each of these time periods, several views on goodwill were articulated and debated. A catalog of these sometimes opposing views, classified according to the temporal partitioning just described, results in a useful chronological taxonomy of issues for tracing the development in the United States of the present position with respect to accounting for goodwill. (See Table 1.)

Table 1

A Chronological Taxonomy of Issues Relating to Goodwill

Time Period		Issue(s)
1900-1932	1(a)	Is goodwill a personal characteristic of an owner of a business entity or can goodwill be associated with the business entity, independent of owner characteristics?
	1(b)	Does goodwill of an unincorporated entity differ from goodwill of a corporation?
	2	Is goodwill a "respectable" asset or is it something to be disposed of as quickly as possible?
	3(a)	Does goodwill diminish in value with use (i.e., is it consumed by use) or does it retain its value until some external event signals a diminution of value?
	3(b)	Is goodwill related to past "good works" or is it the result of expected superior future earnings?
1932-1944	1(a)	Should goodwill that is related to a specific asset or process be given different accounting treatment from goodwill that is not so related?
	1(b)	Do some types of goodwill have a limited useful life, while others have unlimited useful life?
	2	Is purchased goodwill different from internally generated goodwill?
	3	Is it appropriate to value goodwill in a business combination by "difference" (i.e., by computing the excess of the amount paid over the fair

Time Period		Issue(s)
		market value of the tangible and identifiable intangible assets of the acquired entity, less the liabilities of the acquired entity at date of combination)?
1944-1957	1	Is goodwill in a business combination different from (a) other purchased goodwill, and (b) internally created goodwill?
1957-1970	1	Is internally developed goodwill the same as goodwill acquired from other enterprises by purchase? (See Issue 2; 1932-1944, above.)
	2(a)	Is the fair market value of assets given in a purchase combination the best basis for valuation of the acquired entity?
	2(b)	If so, is the fair market value of shares issued in a business combination the best basis for valuation of the acquired entity?
	2(c)	Relatedly, is the fair market value of securities issued in a business combination equal to the fair value of net amounts received?
	2(d)	Is goodwill acquired in a business combination properly calculated by "difference." (See Issue 3; 1932-1944, above.)
	3	Do certain types of business combinations exist in which no recognizable goodwill exists? (See Issue 1; 1944-1957, above.)
	4(a)	If goodwill is to be recognized in the accounts, should it be amortized to income systematically, written off only when evidence of diminution of value occurs, or written off immediately against contributed capital?
	4(b)	If goodwill is to be amortized to income, over what time period should amortization occur? (See Issue 1(b); 1932-1944, above.)

Accounting Principles for Goodwill Prior to 1932

Prior to 1900, some authorities recognized the existence of a valuable characteristic of a business proprietor who enjoyed the respect and confidence of the community in which he lived and worked. Being personal in nature, this value was not considered to be transferable upon the sale of the business entity; nor was the value of the characteristic considered to be diminished by successful operation of the business entity.[5] The notion that goodwill cannot be purchased but rather must be earned by the right dealings and good moral character of the proprietor is in accord with this view.[6]

Around the beginning of the Twentieth Century, corporate goodwill as an asset of a business entity became recognized when businesses were sold as entities for amounts which exceeded the sum of the fair market values of the individual tangible assets of the entities. This excess was considered as a payment to the former proprietor(s) for the goodwill of the business and, in order to initially record the new proprietor's or partners' capital account(s) at the total amount paid, goodwill was recorded as an asset on the books of the resulting entity. It was common practice, however, to immediately write the goodwill off against the proprietor's or partners' capital accounts(s), perhaps in accordance with the earlier view that goodwill was personal in nature and therefore not really a proper business asset.[7]

Of course, the easiest solution to the problem was to insure that goodwill was never created. In the case of goodwill arising in consolidation, this could have been accomplished in one of two ways. The first was to always record the investment in a subsidiary at the net book value of the tangible assets of the subsidiary, treating the difference between this value and the appraised values of the net tangible assets of the subsidiary as additions to or reductions from existing paid-in capital (capital contributed in excess of par) on the books of the parent holding company. Montgomery recommended this treatment in the case of negative goodwill (i.e., in those cases where net book value of tangible assets acquired exceeded the fair market value of the consideration given):

> It cannot be said, however, that good accounting practice requires that the book values of tangible property be written down when holding companies pay less than book value for shares purchased. There is ample authority for crediting capital surplus in the consolidated balance sheets with the excess of book value over cost, except when good-will [*sic*] is carried at a sufficient amount to absorb the excess.[8]

Hence, according to Montgomery, negative goodwill never needed to be created in consolidation.

The second way to avoid goodwill was to always value the tangible assets acquired in a bulk purchase at the fair market value of the consideration given, thereby leaving no excess to be assigned to the intangible goodwill. This was the method recommended by Montgomery in those cases where the fair market value of the consideration given exceeded the net book value of the assets acquired.

> The payment of more than book value means that book values are understated and should be adjusted, or (as is usually the case) there has been a payment for good-will [*sic*]; in such cases the consolidated balance sheet should show the facts. It is not proper nor necessary to deduct the excess from surplus. . . . The auditor may find it necessary to insist on a readjustment in cases where a consolidated balance sheet fails to reflect the reasonable value of assets owned by a subsidiary.[9]

Two observations are in order regarding this suggested procedure. First, Montgomery did not recommend the same treatment for positive goodwill as he did for negative goodwill; i.e., he did not recommend as "proper nor necessary" a reduction of contributed capital by the excess of fair market value of consideration given over net book value of subsidiary net assets acquired. Although the text does not specifically mention the reason for being willing to create contributed capital on the one hand, but not being willing to reduce contributed capital on the other, one would surmise that the reason was an unwillingness to reduce the protection afforded creditors by equity investment of the business.

Second, Montgomery was not clear as to the basis for treatment of the excess, thereby allowing the possibility for avoiding positive goodwill by an upward revaluation of net tangible assets acquired. As a practical matter, the practice of allocating the total value of acquisition consideration to net tangible assets acquired was prevalent, particularly in the accounts of public utilities.

In the case of public companies whose purchase included a payment for goodwill, the English Companies Act prohibited the reduction of contributed capital accounts, since the amounts reported as contributed capital were to be preserved for the protection of creditors. Thus, accountants for such public companies were required to carry purchased goodwill as an asset forever, unless it was to be amortized against income.[10] The more traditional view of goodwill (e.g., that the value of goodwill did not diminish with use) dictated that the asset goodwill should not be amortized against future income.[11] An opposing view, however, suggested that the business asset goodwill was purchased in anticipation of superior future earnings and should therefore be amortized against those earnings in periods subsequent to the purchase/sale of the entity.[12]

Accounting Principles for Goodwill During the Period 1932 to 1944

By 1932, agreement had not been reached between these opposing views, and a wide variety of practices existed ranging from nonamortization to amortization against future income, paid-in capital, and/or retained earnings. Debate over this issue continued for several decades after 1932. The idea that it is desirable to "get rid" of goodwill as soon as possible prevailed as late as 1938 as follows:

> The writing off of such intangible assets as goodwill evokes scarcely any protest, even when it is recognized that substantial goodwill exists. The general distrust of goodwill and the knowledge that it has been widely used to capitalize exaggerated expectations of future earnings leave an almost universal feeling that the balance sheet looks stronger without it . . . nobody seems to regret its disappearance when accomplished by methods which fully disclose the circumstances.[13]

In 1936, the courts were called upon to deal with a problem in utility accounting that resulted in excessive rates being charged to the public. Apparently, utilities would purchase plant assets from other utilities at prices in excess of fair market values (and historic cost values) of the assets, thereby increasing the amount of their asset base, as well as increasing future depreciation write-offs, for rate-making purposes.

With regard to this practice, the court held in 1936 in *American Telephone and Telegraph Co. et. al. v. United States et. al., 299 U.S. 232,* that: (1) The proper basis for valuation of a tangible asset acquired from another utility was "original" cost, which was interpreted to mean the original cost of the asset when *first* dedicated to service by *any* utility; (2) Excess amounts over "original" cost paid by one utility to another to acquire such tangible assets had to be segregated in the records of the acquiring utility; (3) The subsequent disposition of the excess amounts was governed by the circumstances, *viz.,* (a) if the amount is considered as fictitious, it was to be written off against capital accounts immediately, (b) if the amount was considered as being directly related to a specific tangible asset, it should be amortized over the life of that specific related asset, and (c) if the amount was not fictitious and was not directly related to any specific tangible asset, the amount could either remain an asset or be amortized, either against income, to operating expenses, or against invested capital, whichever treatment appeared appropriate in the circumstances.

It is interesting that this position was taken in a court decision rather than by the Committee on Accounting Procedure, perhaps reflecting the fact that the Committee being only two years old at the time, had not yet developed the ability to deal with the issues of the day. Indeed, the accounting profession did not officially take a position until December, 1944, when Accounting Research Bulletin No. 24[14] was released.

Accounting Research Bulletin No. 24 dealt solely with purchased goodwill (i.e., the Bulletin ignored treatment of internally created goodwill) and established the proper valuation basis for purchased goodwill as cost. For this purpose, the cost of goodwill in consolidation was described as the excess of the amount paid (either the amount of cash given or the fair market value of the shares issued, as of the date of the combination) over the fair market value (usually based upon appraisal values at date of combination) of the tangible assets of the acquired entity, less the liabilities of the acquired entity at date of combination. Thus, the propriety of valuing goodwill by "difference" rather than based upon some present value calculation, discounting expected excess future earnings, was established. Further, the amount paid was taken to be the "fair market value of the assets acquired net of liabilities, or the fair market value of the consideration given, whichever is more clearly evident." The presumption was that these two values will be equal in an arm's-length exchange.

With respect to guidelines for subsequent amortization of purchased goodwill, Accounting Research Bulletin No. 24 recognized two types of goodwill—one with definitely limited useful life and another without a definitely limited useful life. The former type of intangible (referred to as a "type a" intangible) was to be amortized to income over the estimated life of the intangible, while the latter type (referred to as a "type b" intangible) was to be carried indefinitely in the accounts until some evidence of a restriction of the useful life of the asset was noted. When such a restriction was noted, it became proper to amortize the intangible against income or, if such amortization would result in distortions in income, a partial write-down to earned surplus (retained earnings) was permitted.

Finally, the pronouncement did not prohibit the initial write-off of goodwill against a contributed capital account but strongly discouraged the practice. Thus, considerable latitude was left to the accountant in deciding upon the proper disposition of a "type b" intangible.

The major criticism of Accounting Research Bulletin No. 24 was that the issue of the proper disposition of goodwill subsequent to purchase was not finally settled by the pronouncement. The latitude allowed in practice resulted in a wide diversity of practices with regard to subsequent disposition of goodwill, with only a minority of companies electing subsequent amortization against future income. This should not be entirely unexpected, since the amortization of goodwill was not allowed for income tax purposes, and election to amortize in the accounts against future income would have produced a reduction in accounting income without corresponding tax benefit.

Accounting Principles for Goodwill During the Period 1944 to 1957

Minor modifications to accounting principles for goodwill were effected in 1953 with the publication of Accounting Research Bulletin No. 43,[15] a revision and restatement of prior bulletins issued by the Committee on Accounting Procedure. Chapter V of Accounting Research Bulletin No. 43 prohibited the lump sum write-off of goodwill at acquisition against either contributed capital or retained earnings, removing the option for this treatment allowed under the previous pronouncement. Write-down subsequent to acquisition was allowed, however, when a permanent decline in value of the asset occurred and when the charging of the amount of the write-down to income would not unreasonably distort income. The amortization of a "type b" intangible (i.e., one with unlimited life) remained optional, as had been the case under Accounting Research Bulletin No. 24.[16]

The seven-year period prior to 1957 did not settle the controversy over the proper disposition of goodwill, once it was placed upon the books of a company. Removal of the option of immediate write-off to stockholders' equity effectively reduced the question as to whether or not the asset should be amortized against future income, and this issue was debated in the literature of the period.

Emerging from this controversy was disagreement over the importance of the distinction between purchased and nonpurchased goodwill, i.e., goodwill acquired by purchase in a business combination and goodwill generated by continuing good management of an already-existing business entity. One point of view held that there should be no fundamental difference in the accounting treatments of either type of goodwill and argued that it would be improper to amortize either type of goodwill in the absence of evidence of decline in the value of that goodwill, since the goodwill being consumed was being replaced by new goodwill resulting from the ongoing efforts of good management. Failure to recognize the replacement of such goodwill as income, while recognizing the wasting of purchased goodwill, would therefore be inconsistent. The opposing point of view argued that, since the recording of purchased goodwill is justifiable only in accordance with the concept of historic cost and recognition of nonpurchased goodwill would require recognition of income prior to realization, purchased and nonpurchased goodwill are conceptually different things. The logical continuation of this argument is that, since the *raison d'etre* for recognition of purchased goodwill is the historic cost principle, this cost should be amortized against the superior future earnings which were purchased. (See Emery[17] for a good synopsis of these opposing points of view.)

Accounting Principles for Goodwill During the Period 1957 to 1970

Accounting Principles Board Opinion No. 17,[18] issued simultaneously with Accounting Principles Board Opinion No. 16,[19] on *Business Combinations,* expressed the prevailing feeling of the accounting profession with respect to the above controversy. In summary, the Board recommended that the cost of intangible assets acquired from other enterprises should be recorded as assets, while the cost in internally developed, maintained, or restored intangibles not specifically identifiable to a particular process or property right should be charged to expense when incurred. For this purpose, cost should be the amount of cash paid, the fair value of noncash assets given, the present value of liabilities assumed, or the fair value of the consideration *received* for stock issued.

With respect to this latter rule in the case of assets acquired by the issuance of stock, Accounting Principles Board Opinion No. 16, paragraph 67,[20] gave tacit approval to substituting the fair value of securities issued for the fair value of assets received when the latter value is difficult to determine. The presumption is that the fair value of securities issued equals the fair value of assets received and, therefore, this alternative valuation yardstick solves the practical problem of having to rely upon subjective valuations of assets where no ready market provides reliable estimates of current market value. It is interesting that this traditional assumption has been retained in Opinion Nos. 16 and 17, in light of prior criticism of the practice, discussed below.

The Board further asserted that all recorded costs of intangible assets should be amortized over some period in the future, not to exceed forty years. In setting this rule, the Board recognized that some intangibles are identifiable with specific processes or property rights and these should be amortized over the estimated useful life of such processes or property rights. On the other hand, other intangibles, such as goodwill, may not be so specifically identifiable. They should, however, be amortized; the only question is "over how long a period of time?" The selection of a forty-year maximum appears arbitrary, intended to provide an outside time period in which to remove the cost of the asset from the books.

Accounting Research Study No. 10[21] appeared in 1968. This study (1) supports the position taken earlier by Arthur Wyatt in Accounting Research Study No. 5[22] that pooling of interests, as a practical matter, is not a valid concept; (2) therefore suggests that goodwill will be present in nearly all business combinations; (3) further suggests that all assets, including goodwill, in a business combination should be recognized at their fair value at date of combination; (4) that the fair value of goodwill in a combination should be determined "by difference," in accordance with conventional practice; (5) further, since there is no conceptual difference between externally purchased and internally created goodwill, there is no justification for amortization of purchased goodwill against future income; and (6) that purchased goodwill, due to its intangible nature and resulting instability of value through time, should be written off immediately at date of merger against contributed capital. The practical result of these recommendations is that the study supports the concept of a fair value pooling, as outlined by Wyatt.

Reaction against Accounting Research Study No. 10 was swift and decisive. The study was attacked for being too broad in scope, therefore asserting conclusions which were unsupported by the study, for recommending nonamortization of goodwill, and for expressing opposition to the concept of pooling of interests.

One criticism of the study is worthy of more than passing note—this being the observations of Homer Kripke, a nonaccountant, on the subject of initial valuation of goodwill in a business combination consummated solely by the exchange of shares. Specifically, Mr. Kripke asserts 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."[23]

In addition to Accounting Research Study No. 10, many other scholarly publications suggest that accounting for goodwill, as presently defined, carries unrealistic valuation implications into the process of financial reporting. Edwards and Bell,[24] for example, suggested in 1960 that the valuation of the firm (and therefore the valuation of the goodwill of the firm) is a subjective judgment which depends upon the perception of the judge. Further, they suggest that there are several different measures of this value. In the case of a company being sold as a going concern, it must be that the market's perception of the value of the firm must exceed management's perception of the value of the firm, or the firm would not be sold. Hence, the actual price paid in the combination must fall somewhere between these two value judgments.

The conclusion from this argument must be that, since both management's and the market's perception of the value of the firm are both subjective and different in absolute amount, the difference must lie in some perceptual error in the respective measurement processes. Further, since the actual price of the exchange, whether paid in cash or in securities, is merely the result of bargaining between these two subjective values, there is no reason to presume that this measurement error is not a part of the valuation process. Any valuation of goodwill resulting from this process must therefore also be subjective and subject to measurement error.

Further insight regarding the reliability of share market prices for valuing the firm and its goodwill may be gleaned from a review of the efficient capital markets literature, resulting largely from research in the field of finance during the 1960s. Essentially, this research is directed at testing the proposition that capital markets are efficient at impounding the effects of information about firms into the security prices of those firms. One implication of this proposition is that, if the market is not efficient in impounding new information, the share price of the firm's securities may not be a reliable measurement of the value of the firm.

The efficient capital market hypothesis in the strong form is of particular interest in this study. In this form, the hypothesis holds that security prices of large, publicly traded companies will reflect not only publicly available information, but private, or "insider," information as well. Empirical evidence in support of the hypothesis in this form is less than conclusive. Thus, one must question the propriety of assuming that the share price of securities in an organized, public capital market properly reflects the value of the firm at any given point in time. One's concern over this point must increase when dealing with a smaller firm whose shares are not traded regularly in an organized market.

This traditional stance with respect to goodwill adopted by the Accounting Principles Board in 1970 (i.e., the reaffirmation of accountability for only purchased goodwill as an asset, valued on a historic cost basis, plus the requirement for amortization against future income from such assets) is indicative of the extent to which the concepts of traditional historic cost and revenue realization were accepted in 1970. This is apparent when one reviews the substantial number of comments by responsible people in opposition to this view during the period 1957 to 1970 and when one examines many of the combinations of the late 1960s in which goodwill values were generated by exchange of shares in ratios which yielded questionable goodwill values, at best.[25]

It is extremely interesting that, even in the face of this rather impressive body of evidence to the contrary, the Accounting Principles Board maintained the profession's traditional posture toward goodwill in Accounting Principles Board Opinion No. 17. Perhaps the reason for this stance is the lack of properly researched alternative views of goodwill. If so, it would appear that research is urgently needed to develop alternative valuation methods for goodwill.

FOOTNOTES

[1]Accounting Principles Board, *Intangible Assets.*
[2]Committee on Accounting Procedure, *Accounting for Intangible Assets.*
[3]Committee on Accounting Procedure, *Business Combinations.*
[4]Accounting Principles Board, *Intangible Assets.*
[5]Yang, p. 28.
[6]Esquerré, p. 245.
[7]Browne.
[8]Montgomery, p. 346.
[9]Montgomery, p. 346.
[10]Catlett and Olson, p. 38.
[11]Esquerré, p. 248.
[12]Leake, p. 87.
[13]Sanders, Hatfield and Moore, p. 14.
[14]Committee on Accounting Procedure, *Accounting for Intangible Assets.*
[15]Committee on Accounting Procedure, *Restatement and Revision of Accounting Research Bulletins.*
[16]Committee on Accounting Procedure, *Accounting for Intangible Assets.*
[17]Emery, p. 562.
[18]Accounting Principles Board, *Intangible Assets.*
[19]Accounting Principles Board, *Business Combinations.*
[20]Accounting Principles Board, *Business Combinations,* pp. 311-312.
[21]Catlett and Olson.
[22]Wyatt.
[23]Catlett and Olson, pp. 136-140.
[24]Edwards and Bell.
[25]For examples of these practices, see Abraham Briloff, *Unaccountable Accounting.* (New York: Harper and Row Publishers, Inc., 1972), and W. T. Andrews, Jr., "The Development of Accounting Principles for Business Combinations—1932-1973" (unpublished doctoral dissertation, University of North Carolina, 1976).

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