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Accounting for Goodwill

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CHANGE has always been a part of the human condition. This is well known. What is not remembered and seldom acted upon is the accelerating rate of this change. Acceleration of change is seen in our total environment, in science, in business, and therefore in accounting.

Three years ago it was said that the year 1910 marked the midpoint in man's scientific development. Today a better figure probably is 1915—in other words, the midpoint moved at least five years in three years. Half the energy consumed by man in the last 2,000 years has been consumed since 1915. Half the minerals and metals ever lifted have been lifted since 1915. Twenty-five per cent of the people that ever lived are now living. Ninety per cent of the scientists that ever lived are now living. It is not hard to believe that ninety-five per cent of the public accountants that ever lived are now living.

We know that the rate of change in our environment continues to increase at an increasing rate, but we act as if we did not believe it. The human mind seems incapable of projecting along an upward bending curve. Instead it looks ahead, although up, on a straight-line basis. This means there is ever a gap between man's ability to solve problems and the problems that require solution.

Now what does all this have to do with by subject—accounting for goodwill? Really very little so far as I can tell. Recognition of accelerating change has had a great deal to do with the advancement of accounting in connection with many phenomena of the day, such as with respect to new types of securities being offered these days by companies, and in connection with earnings per share, accounting for income taxes, pension costs, and the like.

But some of the problems to be dealt with in accounting for goodwill are as old as accounting: They have some of the same dimensions and the same color as those existing when all of us, even the oldest of us, took up our study of accounting. Moreover, the progress toward solution of the goodwill problems moves at a snail's pace.

Why is this? One reason is the remembrance of pain from goodwill abuses of the past. And for this I should like to take a glimpse at history —skip over it lightly, yet nonetheless highlight it enough to set the stage.

THREE MERGER MOVEMENTS

Goodwill considerations have always been associated with merger activity. There have been three great merger movements in the history of the United States: The first started in the 1890s and continued into the early part of the present century; the second came to a peak in the 1920s, and the third, of course, is with us now in the 1960s. Present-day views about goodwill have been importantly influenced by some of the developments and especially by the aftermath of the first two merger movements. One writer has said about the urge to merge:

> The first great merger movement, dating from 1890 to 1904, was relatively simple in motivation. It consisted of building vertical, fully integrated, monster corporations for the purpose of . . . dominating [markets]. The securities offered were so thoroughly watered that it took a generation of industrial growth and the inflation of a world war to dry them out. Unlike what happened in the first round, securities resulting from mergers today are bone dry when offered.
>
> The second great merger movement, starting just after the end of World War I, was checked temporarily by the sharp depression of 1921, and then skyrocketed through all the rest of the 1920s. Corporations were merged to provide glamorous new securities for a speculation-mad public. Stocks of merged companies sold quickly at huge premiums.

There are, of course, two major aspects of the goodwill problem: (1) its measurement initially and (2) the disposal in financial statements of its initial carrying value.

The earliest problem concerned its initial measurement, that is, its initial carrying value.

In 1959, Andrew Barr commented on the early origin of this aspect of the goodwill problem when he said:

> The principal merger problems perhaps for the entire period from the beginning of the century to the present time have been in the accounting for assets and surplus.

Mr. Barr then quoted from George O. May, as follows:

> The problems which the profession now face resemble in some respects that which embarrassed accountants sixty years ago when the great era

> of consolidation began. A legal device sanctioned the recording of the cost of the assets acquired at the face value of the capital stock plus the fair value of any other consideration given therefor. This resulted not only in inflated book values, but also in a lack of a basis for depreciation charges.

Mr. Barr concluded:

> The effect of this practice was still evident in financial statements of many corporations at the time the securities laws were enacted in the 1930s.

GOODWILL BASED ON PAR VALUE—1900–1920

It is little wonder that the accounting writers of the first and second decades of the current century in discussing goodwill found it necessary to deplore the practice of recording goodwill at an amount equivalent to the excess of the stated value of shares issued over the value of the tangible assets received. Among such writers were Bentley, Hatfield, and Dicksee.

By 1910 attention, too, was being directed to the second phase of the goodwill problem; that is, to the matter of amortization. Interestingly enough, views concerning goodwill amortization have not changed materially in the last 50 years. Hatfield wrote in 1916 in part as follows:

> From one point of view it is true that goodwill is the most permanent of assets. Anything else, even the factory site may conceivably be sold without necessarily terminating the business. But goodwill cannot be disposed of without selling the business itself. Furthermore, the very indefiniteness of goodwill renders its overvaluation less harmful than that of other assets. Everyone knows that the price paid for goodwill gives no indication of its present value, and that at any time a new valuation needs to be taken. Hence there is little danger of deception by continuing it among the assets at the cost price. But this doctrine of the permanence of goodwill seems inconsistent with the theory of valuing it as the purchase of a temporary, terminating annuity. Strict logic requires, at least where the price paid for goodwill is definitely based on a number of years' purchase of excess earnings, that the valuation should be written off in the same number of years. To require the writing off only when the expected returns are not realized appears unnecessarily hard on the stockholders for they are doubly burdened: first, by the decline in expected earnings, and then by a further charge against the diminished earnings to cover decline in goodwill. To mark down goodwill when profits are unusually high is clearly illogical, though it

> is not thereby discredited in accounting practice, for it reduces the valuation of excess earnings at the very time and in direct ratio to the increase in such earnings. Probably the most satisfactory solution is ordinarily to write off goodwill in proportion to the number of years figured in its valuation, for in any event it is an uncertain asset, and a depreciation of even fixed assets (in which class it is somewhat forced to include goodwill), while it legally need not be made, is justified on the plea of conservatism. And where it is clear that the valuation of the goodwill was erroneous, that it is not worth its book value, the best method of adjustment is that advocated by Dicksee, to offset the decline in its value by a reduction of capital, not by a charge against profits.

Here in one short passage we see touches of all of the views of that time, as well as now—views that tear at each other because they start from such divergent premises.

AMORTIZATION OF GOODWILL—1920 to 1940

The writers of the 1920s and 1930s, Kester, Finney, Paton, and others were, in general, accepting the notion that only cost was the proper basis for valuing goodwill. Nonetheless, Kester felt it necessary even in 1933 to say:

> The practice of setting up goodwill to fill up the difference between the true value of assets contributed or purchased and the par value of the stock issued can never be contenanced.

The flaming issue of the 1930s, however, concerned the matter of whether goodwill should be amortized. The prevailing view was that it should not. Kester said it this way:

> There is usually no logical reason for writing [goodwill] off. When profits are large, goodwill is a very real asset. To write it off then is not logically consistent. When profits are small and goodwill is accordingly of less value than before, it would hardly be logical to write off any amount less than its decreased value, yet the profits at such a time are rarely sufficient to stand so heroic a treatment.

Paton, on the other hand, as long ago as 1922 was saying that in most cases goodwill should be written off periodically by charges to income, except in the unusual cases where the special factors giving rise to goodwill were permanent; in which situation goodwill should be continued indefinitely as an asset at unamortized cost.

CAMPAIGN DECADES—1930s and 1940s

It might be said that the 1930s and 1940s represented the "campaign" decades—a campaign to eliminate goodwill from balance sheets. The Securities and Exchange Commission certainly was an active force in this campaign. W. W. Werntz summarized the Commission's views on the subject in Chapter 38 of *Contemporary Accounting*, published by the AICPA in 1945. He referred to the Commission's inquiries about goodwill leading to adoption by a number of companies of programs for amortizing it, generally by charges to income. He made it clear that the Commission took a dim view of write-offs against capital surplus.

ARB NO. 24

This then summarizes briefly a bit of the history and a glimpse of the environment giving rise to the issuance in late 1944 of a pronouncement by the AICPA Committee on Accounting Procedure on accounting for intangibles. *Accounting Research Bulletin No. 24* issued in December 1944 dealt with the overcapitalization problem associated with goodwill accounting in the early 1900s by stating:

> In the case of non-cash acquisitions, cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident.

As to amortization of goodwill, *ARB No. 24* adopted the position that goodwill generally was the type of intangible having no limited term of existence, but also approved systematic amortization even when there were no apparent indications of limited life. The Bulletin did, of course, express the Committee's view that goodwill should be amortized or written off as it became evident that its term of existence had become limited or had expired. The Committee, however, did not prohibit direct write-offs against capital surplus, but did discourage such write-offs.

ARB NO. 43—ARB NO. 24 MODIFIED

The next important development was in 1953 when the Committee on Accounting Procedure modified certain of the views expressed in

ARB No. 24. The modified views were expressed in *ARB No. 43,* and may be summarized as follows:

(a) Write-offs of goodwill against capital surplus were proscribed.

(b) Immediate lump-sum write-offs against earned surplus were proscribed.

(c) If not amortized systematically, goodwill should be carried at cost, until an event has taken place which indicates a loss or a limitation on the useful life of goodwill.

CURRENT PRACTICE

This, then, summarizes the present requirements and guidelines with respect to goodwill. As is expected, practice reflects these requirements. *Accounting Trends and Techniques* for 1967 sets forth a summary of the practices followed by the companies covered in the AICPA annual study of stockholders' reports. Of the 600 companies covered in the study, 192 reported a goodwill item in their balance sheets. Their practices were as follows:

	No. of Cos.	*Per Cent*
Goodwill not being amortized	72	38
Goodwill being amortized	43	22
Goodwill shown at nominal value	35	18
Accounting basis not determinable	42	22
Total	192	100%

ACCOUNTING RESEARCH STUDY NO. 10

So much for history. During the last few weeks the Director of Research for the AICPA has issued a research study on accounting for goodwill. The authors of the study are Messrs. George R. Catlett and Norman O. Olson. Because the incidence of goodwill is importantly affected by the extent to which business combinations are accounted for as purchases rather than as pooling of interests, the authors of the study have given considerable attention to pooling-of-interests accounting. They generally endorse the conclusions expressed

in *Accounting Research Study No. 5,* authored by Arthur R. Wyatt, to the effect that most business combinations, whether they involve exchanges of cash for stock or stock for stock, are in effect exchanges and therefore should be accounted for as purchases.

ACCOUNTING FOR GOODWILL

As to the accounting for goodwill, the authors of *Study No. 10* conclude in summary as follows:

(a) The separable resources and property rights acquired in a business combination should be recorded at fair value at the date of purchase.

(b) The difference between the value of the consideration given and the fair value of net separable resources and property rights acquired should be assigned to purchased goodwill.

(c) The purchased goodwill should be accounted for as a reduction of stockholders' equity, either by (1) an immediate direct write-off to capital surplus or *earned surplus* or (2) showing a deduction from stockholders' equity for several periods and later write-off to capital surplus or *retained earnings.*

BASIS OF CONCLUSIONS

Although one would need to consider the entire study to understand the basis for the authors' recommendation about goodwill, perhaps I do not do too much violence to their analysis by summarizing it as follows:

The investor determines the value of a business enterprise. The investor-determined value of a publicly held company is evidenced by the market price of the company's stock. Goodwill, being the difference between the value of an entire business and the value of its net separable resources and property rights, reflects the evaluation of the earning power of the business by investors. Goodwill is not therefore 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 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.

Differences in the nature of purchased goodwill and nonpurchased, or internally developed goodwill, do not support differences in accounting. The current practice of not recording the cost or value of internally developed goodwill is appropriate, since internal expenditures which create goodwill cannot be identified with the particular values which they create. Further, recognition of the value of nonpurchased goodwill in financial statements would introduce investor opinions of values into the financial statements which are designed to furnish information which investors use in arriving at their opinions. In short, "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 apparent uniformity of earning power although no uniformity exists."

DIFFICULTY WITH CONCLUSION ABOUT GOODWILL

I do have difficulty with the conclusion expressed in *Accounting Research Study No. 10* concerning the elimination, or nonrecognition, of goodwill. Since I am restricting my comments today to matters concerning goodwill, I shall not comment at any length on the conclusion concerning the virtual elimination of pooling-of-interests accounting. I am the first to agree that pooling-of-interests accounting has gotten out of hand. It has, however, kept goodwill out of some balance sheets which are better presented without goodwill. The concept of partial-purchase, partial-pooling is surely a difficult one to rationalize. One has to reach a bit, too, to accept the notion that a pooling results when a company issues recently acquired treasury stock in exchange for another company's stock. There are other weaknesses in the guidelines for pooling-of-interests accounting. But these are matters that could be cured without banishment of pooling of interests.

SIMILARITY OF GOODWILL AND OTHER ASSETS

My principal quarrel with the study concerns its premise that goodwill by nature is not a resource of the business and calls for accounting dissimilar from that accorded the assets of a business.

I do not believe that purchased goodwill is so different from pur-

chased tangible assets as to require the strange concept that goodwill is an element of value running directly to the investor in or owner of a business enterprise. It seems to me that the principal conclusion of the study rests on a premise alien to today's accepted structure of accounting; that is, on the premise that in paying for goodwill the purchasing company is making an advance distribution of expected future earnings. As I see it, acceptance of this premise constitutes rejection of another premise that earnings are the result after deducting all pertinent costs from revenue, and this latter premise is so basic to accounting that to reject it requires substitution of a new structure of accounting, and one not articulated in the study.

ASSUMPTIONS

In the analysis that follows, permit me to assume throughout that the goodwill under consideration arose from a business combination in which cash was paid for all the outstanding stock of a company. I make this assumption only to eliminate considerations of pooling of interests from the discussion.

Let us assume further that reasonable determinations have been made of the fair values of tangible assets and separable intangible assets as well as of any amounts appropriately recognizable as additional liabilities. Any excess of the total cash paid over net assets so adjusted then is identified as goodwill, an omnibus term used to characterize such an excess whatever its elements may be. We can go a long way in resolving the goodwill problem by insisting upon a careful analysis of what was bought when a company was purchased and, as a result of such analysis, by first assigning costs to separable assets and then studying the elements of the intangible (that is, the goodwill) to which the remainder of the cost is assigned. As an aside, it may have been semantically unfortunate that such an excess has come to be called goodwill—maybe it would have been better to call it something like "going concern."

WHAT DID THE BUYING COMPANY BUY?

What is the nature of this asset? What was the buying company buying?

I deem it misleading to focus solely on the notion that the pur-

chaser was paying for expected extra earnings. Such narrow consideration of the problem, although perhaps not invalid, often leads to the inference that the amount of the goodwill should remain in the balance sheet as long as the earnings stay up, since that would be evidential of the value of the intangible. But that line of reasoning views accounting as having solely a balance-sheet valuation emphasis—that an asset need not be amortized as long as the value of the asset holds up. A logical consequence would be to argue that depreciation need not be recognized as long as the productivity of the tangible asset stays up.

I deem it more fruitful to deal with goodwill by focusing on its similarities with tangible assets rather than on their dissimilarities.

Now back to the question: What does a purchasing company buy when it pays for goodwill?

Going-Concern Elements

In the first place, it pays for some of the things required to make a going concern out of an aggregation of tangible assets. These were things that the company acquired had already paid for and had expensed. In other words, some of the payment went to reimburse the shareholders of the company acquired for costs incurred by their company, which in turn had resulted in lower distributable earnings. To put this another way, the purchaser chose to go into business by buying an enterprise that was off and running rather than by forming a business and incurring separately all the costs required to make a going business out of an aggregation of assets, and in doing so he had to reimburse the sellers for costs they had incurred to the extent values continued.

Inflation

In the second place, with respect to these going-concern elements, it may be paying out extra current dollars above costs incurred and expensed by the company acquired simply because of the inflation that has occurred since the acquired company incurred such costs.

Fortuitous Non-Cost Factors

In the third place, the purchasing company may have paid for some non-cost factors that have resulted in a higher "going concern"

value than that of some other companies. These factors may be external to the business or internal and may have risen fortuitously.

Attitudes and Expectations

Finally, it may be paying for indefinable factors resting solely in its own expectations and attitudes as well as the expectations and attitudes of other investors. This class of factors comprehend all those subjective elements affecting the market for a company's stock. Taken individually or as a whole, they may at times appear to be irrational.

For convenience of discussion, I shall characterize these factors as (a) going-concern elements, (b) price-level adjustments, (c) fortuitous developments, and (d) expectations and attitudes. I recognize that not often in a given case is it possible to assign goodwill costs to each of these factors; nonetheless, recognition that they are present sheds some light on the goodwill problem.

GOING-CONCERN ELEMENTS

During the life of a company, costs are incurred and expensed for a number of factors that add value to a company in excess of the aggregate value of its separable assets. These factors include such things as:

(a) Formation of an effective labor force. This would include hiring, training, and programs intended to promote low turnover and high productivity.

(b) Development of an effective organization. This would include formation of a management team, a sales organization, and the like.

(c) Development of public image and consumer acceptance. Activities directed toward these ends would include community and public service activities, advertising, and a contribution program.

These factors, like tangible assets, are assets because they are expected to benefit the future. The lives of these factors are more difficult to estimate and probably more likely to expire abruptly than those of tangible assets, but the economic similiarities of these two classes of assets are significant. In some instances the probability of future benefits from these intangible factors would seem to continue indefinitely.

On the other hand, most of them would appear to have limited life. It is doubtful if any significant part of their value persists indefinitely.

INFLATION FACTORS

In the preceding section, mention was made of the payment for factors as to which a cost previously had been incurred—a sort of cost-reimbursement analysis. To the extent that current price levels are greater than those when the costs were incurred, a higher current cost results. No special treatment of this element of goodwill cost seems required. Whatever treatment fits the going-concern element fits the inflation factor, since one is a part of the measurement of the other.

FORTUITOUS ELEMENTS

Some elements of goodwill may arise fortuitously or, at least, without significant cost. Among such factors may be a favorable location, favorable tax circumstances, favorable government regulation, and unusually outstanding management qualities. Unfavorable developments affecting competitors may also give a company a relative advantage that demands a price in the event the company is acquired.

The service lives of such factors are, at best, indefinite and, at worst, fleeting. Estimates of such service lives perhaps are seldom better than arbitrary.

ATTITUDES AND EXPECTATIONS

Then there are those indefinite, in fact unidentifiable, factors that cause the market values for a company's stock to fluctuate quite apart from the developments within a company or within an industry. These are those unpredictable psychological factors—call them attitudes or expectations. At any given time, the price paid for a company's stock may include an "excess cost" simply because the transaction occurred when attitudes concerning the company's future are unusually favorable.

Attitudes and psychological factors, of course, are transient and often ephemeral. The odds are that any estimation of their duration will be wrong, significantly wrong.

CONCLUSIONS

I draw several conclusions from this analysis.

The first is that goodwill is not so different from tangible assets as to justify an accounting treatment outside the basic structure of accounting. In sum, this means that the cost incurred in acquiring goodwill is to be dealt with as the cost of a resource used in the business.

The second conclusion I draw is that, in most instances, estimates of service lives of the elements of goodwill can be little better than arbitrary. As mentioned earlier, some of its elements have fleeting life and some seem to endure for a long time. It is doubtful however, in my mind, whether any significant elements of goodwill will last throughout the life of the company. I am not very hopeful either that in many cases would it be possible to develop verifiable evidential matter supporting estimates of service lives of goodwill elements.

Here, then, is the nub of the problem. Is the nature of goodwill such that its cost should be amortized systematically or is this the type of asset that should be written off either immediately upon incurrence or when an event occurs that demonstrates extinction of an asset? Here are three possibilities. I conclude that one thing is common to all of them—the charge should be to income.

Systematic Amortization

The argument for—I would say, the presumption for—systematic amortization rests principally in the premises that the cost of goodwill was incurred to obtain future benefits and that the elements so acquired do have limited life. The principal argument against systematic amortization relates to the high degree of uncertainty about the future period to be benefitted. How does one estimate the service life of a favorable location, the results of an employee training program, a favorable management situation? Arbitrary estimates seem necessary if systematic amortization is to be the general rule. This raises an important question about whether periodic determinations of net income based importantly on arbitrary allocations of a cost are more meaningful than those based on no allocation at all. It might be argued with considerable cogency, on the other hand, that systematic amortization could be effected without arbitrary allocation, even though the service life of the

elements of goodwill, as elements, cannot be reasonably estimated. This might be done by using an amortization rate equivalent to the rate that a prudent investor would expect in the way of a return on a certain type of speculative investment. The rationale for this approach would be that such a rate underlies the expectation of the purchaser when he willingly incurs a cost for goodwill, and that the rate therefore is real, not arbitrary; hardly verifiable, nonetheless relevant.

Immediate Charge to Income

One way to avoid arbitrary allocation would be to write off the cost of goodwill upon incurrence by an extraordinary charge to income. An argument for this approach is that costs like goodwill costs are traditionally expensed as incurred. Returning again to my so-called going-concern elements of goodwill, that is, the cost-reimbursement elements, employee training, costs of organizing sales departments, and the like. These costs are conventionally expensed as incurred, and to the extent that a purchaser pays for these things in buying a business, he too should expense the cost as incurred—or so the argument would go. There are differences too, however. In the first place, we now would be considering a bunching of such costs rather than incurrence over perhaps a long period of time. In the second place, immediate charge-off flies in the face of reasonableness or prudence. An investor has just incurred the cost, presumably to obtain some future benefits; certainly not to obtain benefits that will disappear coincident with purchase.

Defer Until an Event Occurs

Another way to avoid arbitrary allocation is to approach the goodwill problem assuming that no reasonable estimate can be made of the service lives of the elements comprising goodwill, by continuing the deferral of its cost until an event occurs resulting in limited remaining life or extinction of the goodwill, and then writing it off accordingly. The principal argument against this approach is that such events often do not occur in an identifiable way. Disappearance of the elements of value of goodwill may be gradual and in fact may have disappeared without any sign of extinction simply because new elements have re-

placed them—and this may not be an uncommon situation. But then a new arbitrary factor may have been introduced—that is, the arbitrariness of the conclusion on whether an event has or has not occurred.

The next year should see much discussion of this problem in the profession, as well as in the financial community. All of us should take part in this activity. My principal purpose today was to set the stage and indicate a type of analysis of goodwill which, I think, merits careful attention.