Accounting for Goodwill

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Abstract
In lieu of an abstract, below is the first paragraph of the paper.

Goodwill has become an increasingly larger portion of the assets transferred to a company during an acquisition. Financial statement users are now in need of better information about goodwill. This paper will (1) compare the prior method of accounting for goodwill to the new method of accounting for goodwill, (2) examine some of the controversies surrounding the accounting method, and (3) examine some of the effects the new accounting method has had on businesses. Goodwill has become an increasingly larger portion of the assets transferred to a company during an acquisition. The value of many companies has shifted from land, buildings, equipment and other tangible items to intangible (and sometimes unidentifiable) items such as brand name, market reputation, efficient and effective internal processes, customer lists, and level of customer loyalty. Financial statement users are now in need of better information about goodwill. This paper will compare the prior method of accounting for goodwill to the new method of accounting for goodwill. The change in method has created controversy. The interpretation of the kind of asset goodwill represents is part of the controversy. The most useful method of recording the decline in value of goodwill is another part of the controversy. The method of recording the decline in value becomes particularly controversial when examined in terms of reliability. This paper will further explain the arguments of this controversy. Finally, this paper will identify the different stakeholders who will be affected by the implementation of the new accounting method.
Accounting For Goodwill
By Julie Bennett

Abstract
Goodwill has become an increasingly larger portion of the assets transferred to a company during an acquisition. Financial statement users are now in need of better information about goodwill. This paper will (1) compare the prior method of accounting for goodwill to the new method of accounting for goodwill, (2) examine some of the controversies surrounding the accounting method, and (3) examine some of the effects the new accounting method has had on businesses. Goodwill has become an increasingly larger portion of the assets transferred to a company during an acquisition. The value of many companies has shifted from land, buildings, equipment and other tangible items to intangible (and sometimes unidentifiable) items such as brand name, market reputation, efficient and effective internal processes, customer lists, and level of customer loyalty. Financial statement users are now in need of better information about goodwill. This paper will compare the prior method of accounting for goodwill to the new method of accounting for goodwill. The change in method has created controversy. The interpretation of the kind of asset goodwill represents is part of the controversy. The most useful method of recording the decline in value of goodwill is another part of the controversy. The method of recording the decline in value becomes particularly controversial when examined in terms of reliability. This paper will further explain the arguments of this controversy. Finally, this paper will identify the different stakeholders who will be affected by the implementation of the new accounting method.

The New Accounting Method
For many years, goodwill was accounted for similarly to other intangible assets. A company would estimate the useful life of the goodwill it incurred, which could be as much as 40 years, and would amortize the goodwill over the estimated life. In June of 2001, the Financial Accounting Standards Board (FASB) issued SFAS 142. This new statement on Accounting for Goodwill and Other Intangibles no longer allows companies to amortize their goodwill. Companies are now required to test goodwill on an annual basis for impairment. Impairment tests are familiar to the accounting industry. They are used for the write-downs of accounts receivable to net realizable value, of inventory to lower of cost or market value, of property plant and equipment to current market value (Massoud and Raiborn, 2003). Other intangible assets that are determined to have a finite useful life will continue to be amortized.

The new accounting approach for goodwill is a two-step process. In the first step, a company must estimate the fair value of the reporting unit that the goodwill is attached to and then compare the fair value to the carrying value (including the goodwill) of that reporting unit. If the fair value is greater than the carrying value, then goodwill is not impaired and should not be reduced. Companies are not allowed to record a gain to goodwill if the fair value is determined to be greater than the carrying value. If the fair value is less than the carrying value, then the company must continue to the second step. In the second step, a company would apply the fair value it had calculated to the assets and liabilities of the reporting unit. The remaining balance of the fair value is the new value of goodwill and the carrying value of goodwill should be reduced to the new value. Initial impairment charges in December 2001 and in 2002 could be reported as extraordinary losses, however impairment charges in subsequent periods should be recorded as an operating expense.

The impairment test may be performed at any time during the year, so long as date is consistent from year to year. Additionally, companies must perform an interim test if a triggering event occurs. Examples of triggering events include market decline, regulatory action, new competition or a loss of key personnel (Moehrle and Reynolds-Moehrle, 2001). Companies will also have to perform an interim measurement if they plan on selling or disposing of a reporting unit or a material portion of one.

Goodwill cannot have a fair market value as a stand alone asset because it represents an intangible value created by a combination of other tangible and identifiable intangible assets. Because of the nature of goodwill, the definition of a reporting unit is vital to assessing its value. A reporting unit is described as the level of a business that management reviews and assesses as a separate segment. Reporting units can be distinct business lines, geographic segments, or even the company as a whole if no reporting unit exists (Moehrle and Reynolds-Moehrle, 2001). A company can also use a level of operation within the reporting unit if financial data of the functions of that level are available.

Issues involved with the New Accounting Method
FASB made a major change in its interpretation of goodwill when it issued Statement 142. Under the prior statements, goodwill was considered a wasting
asset with a finite useful life. Under the current statement, goodwill has the potential for an indefinite useful life. CPA Mike Mathieson, former vice-president and controller of Fortune Brands, Inc. agreed with FASB's new interpretation of goodwill: "If properly managed, goodwill is an appreciating asset, and if not, the impairment test will recognize the reduction in value" (Moehrle and Reynolds-Moehrle, 2001). However a study published in 2003 examined the amortization life assigned to goodwill to see if it could predict the firm's post-acquisition earnings levels. The results of the study "suggest that the amortization life chosen is a reliable predictor of the success of the acquisition both in terms of earnings changes and future stock performance" (Henning and Shaw, 2003). The study indicates that goodwill's ability to generate revenue is limited to a certain number of years and that companies have been successfully estimating the number of useful years of their goodwill. CPA Patricia McConnel, senior managing director at Bear, Stearns & Company, Inc. agrees with the study that although goodwill has a definite life, "it does not decline in value over a straight line for an observable period. Its value will be stable or increase for long periods, then an event or series of events will cause it to decline" (Moehrle and Reynolds-Moehrle, 2001). Further along this line of thinking, companies may find that the reporting unit may lose fair market value as a stand alone operation because of the cost-savings associated with being in a larger organization. Purchased goodwill may be greatly impaired while significant internal goodwill is created. FASB's requirement of impairment testing may be an improved method of recording the decline of the value of goodwill but since the appreciated value of purchased goodwill and internally generated goodwill are not recorded, the financial statements still will not truly reflect the extent of the impact of the purchased goodwill.

The discussion of whether or not goodwill has a limited life leads right into another discussion on the usefulness of the measurement of fair value of goodwill. The goodwill amortization charge in prior years has often been viewed as unimportant. Since the prior rules required goodwill to be written down each period, the amortization expense bore little relation to the operations of that period. CPA James Bean, director of accounting policy at Golden State Bank in San Francisco said, "Wells Fargo, the largest West Coast bank, pioneered the concept of 'earnings per share before amortization of goodwill' in its earnings releases...most banking analysts have been deducting the amount of goodwill amortization to arrive at a bank's core earnings" (Moehrle and Reynolds-Moehrle, 2001). Furthermore, users were unable to distinguish the amount of goodwill for many companies because it was often grouped in with other intangible assets. Under the new accounting method, the determined value of goodwill should be based on expected operations in future periods, thus tying the value of goodwill to the underlying economics of the reporting unit. Patricia McConnel noted that, "a goodwill impairment charge may be an important signal of a decline in a business for reasons not obvious to financial statement users" (Moehrle and Reynolds-Moehrle, 2001). The study mentioned earlier indicated that companies have been successfully estimating the number of useful years of their goodwill. The new accounting method requires companies to use estimates about the future cash flows of the reporting unit goodwill is attached to. Companies already use estimates about future cash flows to aid in tax litigation, contract negotiations and shareholder disputes (Lieberman, 2003). By blending useful life estimates and cash flow estimation techniques, a company could reasonably create an internal, reporting unit valuation model. A company should use the same valuation model each period to promote consistency. Comparability might suffer because companies within similar industries may define reporting units on different levels or they may use different valuation techniques, and the companies would not be required to disclose the details users need to understand these decisions. Again, however, an accurate impairment test should reflect the underlying economics of the industry.

Of course the valuation of goodwill is only useful if it is reliable. The opportunity and temptation for fraud exists whenever companies must use estimates. The use of estimates for the valuation of reporting unit is no exception. Accounting standards have typically focused on historical cost because of the skepticism generated by the use of estimates (Lieberman, 2003). The new accounting method for goodwill may be another window for companies to manipulate earnings and book value.

Effects of the New Accounting Method

One immediate effect of the new accounting method is companies that carry goodwill will no longer have to recognize an amortization expense each period. So the new accounting method may be good news for some companies, but it is bad news for others. For instance, AOL recorded goodwill impairment in 2001 of $54 billion and in 2002 of $45.5 billion and Boeing recorded goodwill impairment in 2002 of $2.41 billion and in 2003 of $931 million (Rapoport, 2003). While these companies stress that these are non-cash expenses that do not impose on operations, they also indicate that the impairments are a reflection of the current economic conditions. So the new method of accounting for goodwill will help some companies in industries that are prospering, but it will hinder other
companies that are in industries that are currently in an economic slump or that frequently experience recessions. The construction industry has the second highest failure rate in the United States (Davidson and Vella, 2003). Companies in the construction industry are extremely vulnerable to economic conditions, so the value of their goodwill is too. Accountants in this industry recommend a conservative benchmark for goodwill valuation of about 15 years due to high risk in the construction industry, high competition rate, and unpredictable future (Davidson and Vella, 2003). Perhaps a study someday will be able to link impairment charges to industry economic indicators. Currently, impairment charges are a good indication that a reporting unit is not performing as well as the company had expected upon acquisition. Impairment charges may also indicate that an acquisition cost too much. So, the new accounting method of goodwill may push companies to really scrutinize the value of a potential acquisition. In fact, impairment charges recognized after the first year, as part of operations, could really hurt companies. Although it has been the practice to take goodwill amortization out of earnings reports, accounting scandals and subsequent increased skepticism may not be so willing to overlook the write-down especially if it is a material amount. With increased attention on the carrying value of goodwill, companies will have to take precautions to ensure they provide accurate valuations. Fair value measurements may even require the assistance of outside experts.

Companies are not the only stakeholders affected by the new accounting method. Creditors will have to become familiar with goodwill valuation techniques and the triggers behind an impairment charge. Some of their clients’ income will rise because they will no longer have to record an amortization expense each period. The sudden rise in income might be mistaken for improved operations. Other clients’ income may be dramatically reduced due to the large impairment charges. The lower income might be mistaken for an indication that a customer is in serious financial trouble. Furthermore, if a company recorded a large impairment charge one year, that company may not record another impairment charge for several years. So creditors will have to create their own technique of estimating and planning for their clients’ goodwill impairment (Dennis, 2003). Analysts will also have to prepare methods of evaluating how companies treat the new accounting method for goodwill. For instance, Tyco has been scrutinized for carrying too much goodwill on the balance sheet. The company recorded a goodwill impairment in 2003, but not as much as analysts had expected (Maremont, 2003). Tyco’s stock price rose on the day this information was released because Tyco had also announced restructuring plans that would reduce costs and other promising plans for the future. In this situation, skepticism about the carrying value of goodwill did not outweigh the other stock valuation criteria. In fact, many say that the stock prices of companies that are candidates for goodwill impairment have already dropped as a reflection of doubt in the value of acquisitions (Sender, 2002). Lawrence Hamden, the managing director and co-head, industrial mergers and acquisitions, at Credit Suisse First Boston Corp. agrees, “Some companies are concerned about taking a large impairment charge if an acquisition does not turn out as expected. Although this is a risk, the market is likely to already sense an acquirer has overpaid for a business even before such a write-off is recorded” (Moehrle and Reynolds-Moehrle, 2001). Another important stakeholder affected by the new accounting method is the auditor who must determine whether or not a company has properly defined the reporting unit and determined its fair market value in accordance with the generally accepted accounting principles established by FASB. Auditors must understand valuation techniques if they are going to certify that the techniques were performed correctly.

Auditors, analysts, creditors, and companies face adjustment to the method of accounting for goodwill. Even though many aspects of the new method are controversial, the method must be implemented and adhered to. Currently, companies are under tremendous pressure to accurately report earnings due to the many recent events that have discredited the accounting profession. The current environment is probably the best environment for the new accounting method to be introduced into. Companies, which are being closely watched, have a great incentive to accurately define their reporting units and determine their value using techniques that could be supported against the even the toughest critics.
References


