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Accounting for goodwill: An academic literature review and analysis to inform the debate

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ABSTRACT

Goodwill in the accounting context represents amounts paid in excess of the fair value of the identifiable net assets for a business acquisition. The accounting for goodwill has long been a subject of debate and remains so today. Indeed, the guidance for goodwill accounting has been significantly revised by regulators twice since 2001 (2001 and 2011). Despite these recent and significant revisions, the topic is back on the Financial Accounting Standards Board (FASB) agenda as the FASB added a project to once again discuss the optimal treatment for goodwill (Financial Accounting Standards Board, 2015). In this paper, we seek to inform this effort by describing the evolution of accounting standards for goodwill and then synthesizing and analyzing the academic literature on goodwill accounting and reporting. Based on this historical perspective and analysis of the literature, we then assess the strengths and weaknesses of different accounting approaches for goodwill, highlight the factors affecting the process of standard-setting on goodwill, and make recommendations. Our recommendations include recommendations for the FASB about optimal guidance and recommendations for academics concerning future academic research projects that would advance the goodwill accounting debate. Hence, this paper should be of interest to regulators and standard setters, academic researchers interested in mergers and acquisitions and goodwill, and financial statement preparers and users.

Introduction

Goodwill in the accounting context represents amounts paid in excess of the fair value of the identifiable net assets for a business acquisition. Goodwill is a prominent asset and often the largest dollar value intangible asset on the balance sheets of U.S. companies. For example, goodwill has been, on average, 14–15% of total assets for about half of U.S. public firms that report non-zero goodwill on their balance sheets from 2005 to 2013 (Wen & Burger, 2015). In addition, Li and Sloan (2014) show that goodwill has become an increasingly significant balance sheet asset from 1990 to 2007. Hence, goodwill is a significant component of the balance sheets of many companies and warrants scrutiny regarding how to best measure and report it.

Goodwill is a complex economic construct that is once again on the FASB's project agenda (Financial Accounting Standards Board, 2015). Because of this complexity, the Financial Accounting Standard Board (FASB) has revised goodwill accounting and reporting several times over the years in continuing attempts to improve. For example, the FASB has issued three pronouncements regarding goodwill since 2001. In 2001, the FASB issued Statement of Accounting Standards (SFAS) No. 141 (Financial Accounting Standards Board, 2001a) and SFAS No. 142 (Financial Accounting Standards Board, 2001b), which eliminated the "Pooling of Interests" (pooling) method as an alternative for recording the original business combination and eliminated amortization of the recorded goodwill asset under the acquisition method. Instead of amortization, SFAS No. 142 mandates an annual goodwill impairment testing.

In 2011, in response to concerns that the annual goodwill impairment test involved unjustifiable compliance costs, the FASB issued Accounting Standards Update (ASU) No.

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2011-08 (Financial Accounting Standards Board, 2011). This guidance relaxed requirements in step one of the multi-step process for conducting the annual impairment testing. In November 2013, the FASB added a project on goodwill accounting intended to further reduce the cost and complexity of goodwill accounting. Two months later, in January 2014, the FASB issued ASU No. 2014-02, which simplified goodwill accounting for private companies. The expedient allows for amortization of recorded goodwill over the lesser of 10 years or the useful life and reduces the impairment test to a one step calculation. An entity choosing the simplification chooses to test goodwill and the entity or the reporting unit level. Goodwill is tested for impairment when a triggering event indicates that the fair value of the entity (or the reporting unit) may have fallen below the carrying value. The impairment amount to be recognized is the amount by which the carrying value exceeds the fair value of the entity (or reporting unit). This action addressed concerns about the costliness of goodwill accounting for privately held companies. However, the project remains on the agenda as the FASB debates the issue for all companies.

At a meeting in March 2014, four alternatives for goodwill accounting were considered: (1) amortize goodwill over the lesser of 10 years or the estimated useful life of the goodwill asset; (2) amortize goodwill over the estimated useful life and conduct impairment testing as well; (3) write-off goodwill at the acquisition date; and (4) apply a simplified impairment testing model with no amortization. These four alternatives reflect the essence of goodwill accounting debates over the years. That is, whether goodwill is an economic asset, whether goodwill is an accounting asset, whether goodwill is fundamentally a wasting asset, whether and how the useful life of goodwill can be estimated, and whether the ongoing fair value of goodwill can be estimated reliably.

In this article, the academic literature is reviewed and synthesized to inform this debate.[1] First, the evolution of generally accepted accounting principles related to goodwill is summarized. Next, findings from the academic literature are synthesized including perspectives from the stockholders and bondholders. The respective stakeholder perspectives are important to fully assess strengths and weaknesses of the various proposals for treating goodwill. Findings from non-U.S. accounting regimes are also presented since accounting treatments similar to those being proposed have been applied in other countries. For example, the immediate write-off of goodwill has been applied in the United Kingdom. U.S. regulators, practitioners, and academicians can learn from these data, observations, and experiences. The paper concludes by analyzing findings in the literature to identify open questions that should be addressed to further inform this debate.

This paper proceeds as follows. The next section discusses the economic substance of goodwill and summarizes the evolution of goodwill accounting guidance in the U.S. Goodwill research findings related to recognition and to subsequent write-off, amortization, or impairment are then presented from the equity holders' perspective. Next, analyses are conducted from credit market perspectives including the impact of goodwill derecognition on debt contracts. The next section presents analyses of academic studies of goodwill accounting in countries and accounting regimes outside of the U.S. Next, the paper summarizes the state of the art in goodwill, makes recommendations for future goodwill accounting changes, and identifies open research questions to further inform the debate. The final section concludes the paper with a synthesis and analysis from the regulatory viewpoint.

The economic nature of goodwill and the accounting for goodwill

The nature of goodwill

Goodwill amounts theoretically represent amounts of incremental investment paid to earn abnormal returns on investments. These abnormal returns arise from various sources and for various reasons (Courtis, 1983). This has long been recognized by economists. In an early discussion of goodwill, Dicksee and Tillyard (1906) described goodwill as, "whatever adds value to a business by reason of situation, name, reputation, connection, introduction to old customers … and there may be others which do not occur to me." One example these authors use as goodwill is "old customers will resort to the old place." While current accounting allows for the capitalization of customer lists as identifiable net assets, this quote conveys the essence of thought on goodwill and demonstrates how long thinkers have debated goodwill and its accounting.

Over the past century, the global economy has consistently produced technological innovations and knowledge advancements (Hughes, 1982). Consistent with this, Cañibano, García-Ayuso, and Sánchez (2000) argue that goodwill is connected with intangible investments such as human resources, new technology, research and development, and advertising. Their overarching point is that goodwill is an economic asset with expected future value just like tangible assets such as inventory and property, plant, and equipment.

In the legal literature, goodwill is viewed as deriving value from rights and privileges. Osborn (2012) put it this way: "for legal purposes, goodwill is a bundle of rights and privileges enjoyed by the owner of an operating business, central to which is the proprietary right to make use of all that constitutes the attractive force of the business to generate earnings or otherwise create value."

The economic and legal professions have identified the economic and legal substance of goodwill. The accounting profession must then determine how to account for it. The debate over goodwill from an accounting perspective centers on: (1) what are the probable future economic benefits; (2) how significant are these benefits; and (3) how long will these benefits sustain into the future. These questions are reflected in changes to the accounting standards associated with goodwill over the years.

[1] See Cañibano et al. (2000) for a review of the literature that focuses on off-balance-sheet intangibles, such as research and development expenditure.