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Accounting for Goodwill: Back to the Good Old Days?

Dissatisfaction with present accounting standards for goodwill has prompted standards setters and their constituents to look to the past for potential relief.

Accounting for goodwill has long been controversial. Much of the controversy has revolved around the recognition and measurement of goodwill assets that arise from business combinations. Significant changes to accounting standards for such assets were made in the early 2000s, but preparers, auditors, and users of financial statements continue to press for change. In most cases, the change that those stakeholders are seeking is essentially a reversion to previous standards. This column will explore recent actions that standards setters have taken toward reinstating "traditional" accounting for goodwill.

Background

Unlike other assets, goodwill can't stand alone—it isn't separable or distinct from the reporting entity as a whole. Under U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), goodwill is recognized only as a result of a business combination or similar transaction involving not-for-profit entities. In such transactions, goodwill reflects the extent to which the acquisition price paid for the acquired entity, as a whole, exceeds the sum of the individual fair values of the entity's net assets (i.e., assets less liabilities). That measurement approach has led to goodwill being described as the amount by which "the whole is greater than the sum of its parts."

Both U.S. GAAP and IFRS consider goodwill to be an intangible asset that has an indefinite useful life. As such, it isn't systematically amortized to expense over time like other intangible assets, but it must be tested regularly for impairment. In practice, goodwill almost always gets written down over time as a result of impairment testing, and it often becomes significantly impaired relatively soon after its initial recognition.

Investors, creditors, and other users of financial statements have questioned the usefulness of reporting goodwill. Goodwill has no realizable value by itself. It can't be used as collateral for borrowing. And under current accounting standards, the measurement of goodwill subsequent to its initial recognition involves significant estimation and judgment. For all these reasons, financial-statement users often ignore goodwill when analyzing financial statements and make a corresponding mental deduction from the reporting entity's equity. Additionally, preparers and users of financial statements have expressed concerns about the cost and complexity of the goodwill-impairment testing that current accounting standards require.

Walking It Back

The current accounting treatment of goodwill is relatively new. Before the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 142 (SFAS No. 142), "Goodwill and Other Intangible Assets," in 2001 and the International Accounting Standards Board (IASB) issued IFRS 3, "Business Combinations," in 2004, goodwill was amortized and not continually subject to costly and complex impairment testing.

In recent years, there have been several standards-setting initiatives that have effectively revived this older accounting treatment for goodwill. For example, in July 2009, the IASB published the "International Financial Reporting Standard for Small and Medium-sized Entities" (IFRS for SMEs). As

I explained in my September 2009 column, "A Game-Changer for Small-Business Accounting," the IFRS for SMEs is a complete set of country-neutral financial accounting and reporting standards for entities that lack public accountability, which are typically smaller than entities that are publicly accountable. Under the IFRS for SMEs, goodwill must be amortized over its estimated useful life, with a maximum amortization period of 10 years.

More recently, on June 10, 2013, the FASB endorsed, for purposes of public exposure, a recommendation by its Private Company Council (PCC) to modify U.S. GAAP such that a private company could elect to amortize goodwill over a period not to exceed 10 years. The PCC's recommendation also included simplified impairment testing for goodwill.

On the same day, the American Institute of Certified Public Accountants (AICPA) released a new non-GAAP set of accounting standards called the "Financial Reporting Framework for Small and Medium-Sized Entities" (FRF for SMEs). The Framework requires that goodwill be amortized over the same period as that used for federal income tax purposes—or, if not amortized for federal income tax purposes, then a period of 15 years. Furthermore, the Framework doesn't require goodwill to be tested for impairment.

Outlook

Debate and discussion about alternatives to current goodwill accounting continue. On June 7, 2013, the European Financial Reporting Advisory Group (EFRAG) published a "Feedback Statement" that summarized responses the Group obtained from a questionnaire about the measurement of goodwill subsequent to its initial recognition. The Statement, available at www.efrag.org, does an excellent job of summarizing the thinking of diverse stakeholders on key issues related to goodwill accounting.

Will contemporary accounting standards for goodwill eventually be considered a "failed experiment"? It's too soon to say for sure. But based on the present sentiments of participants in the financial reporting supply chain, future goodwill-accounting standards may bear a greater resemblance to past standards. **SF**

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