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PURCHASED GOODWILL AND ITS ACCOUNTING TREATMENT

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When a company decides to purchase another company or enterprise, the consideration paid will, in many cases, exceed the total of the separate valuation of each of the assets and liabilities of the company or enterprise being purchased. The extent of the premium paid is sometimes dependent on the growth potential of the company in question. In other cases, the premium is linked to the possibilities for cost-cutting when synergies between the existing and new companies are exploited. Occasionally, the fact that a company has an established reputation or an established customer base will result in a considerable premium being paid by the acquirer. The premium paid is referred to as Goodwill and the accounting treatment of this premium has been the centre of an accounting controversy for some time.

Until recently, the standard practice on purchased goodwill was dictated by Statement of Standard Accounting Practice (SSAP) 22, *Accounting for Goodwill*, which was issued by the Accounting Standards Committee (ASC) in July 1989. Two practice treatments were allowed.

The first and preferred treatment was to eliminate the purchased goodwill from the accounts immediately by debiting or reducing revenue reserves. [1] The main rationale for this accounting approach was that, since goodwill is not normally treated as an asset in the balance sheet, it would be incorrect to account for goodwill as an asset just because it was purchased. When this method is used, goodwill does not appear as an asset in the balance sheet and the profit figure in subsequent years is not affected.

The second treatment is to consider the purchased goodwill as an asset on the balance sheet since this is an item for which you have paid. The goodwill is then systematically amortised through the profit and loss account over its useful economic life.[2] In this case, profit is reduced in subsequent years by the amortisation charge (which is similar to a depreciation expense).

Not surprisingly, most companies in Ireland and, in particular, the United Kingdom (where there is considerably more take-over activity and, hence, more situations where goodwill accounting arises) decided on the option which would not reduce profit in subsequent years. A survey was carried out by the Department of Accounting and Finance of Lancaster University in order to examine the treatment of purchased goodwill in the financial statements of the larger companies. Immediate write-off to reserves was the goodwill treatment most widely used by respondents (80.3%). Only 11.4% of respondents

[1] SSAP 22, paragraph 39.

specified capitalisation and gradual amortisation. The results of this survey have been supported by similar studies of reporting practice.[3] The favourable effect on reported future earnings undoubtedly contributed to this preference for the write-off method.

The Accounting Standards Board issued a Working Paper on Goodwill and Intangible Assets in June of 1995. Subsequently, the ASB issued Financial Reporting Exposure Draft (FRED) 12 on the same topic and, finally, in December 1997, the ASB issued Financial Reporting Standard (FRS) 10, *Goodwill and Intangible Assets*. This new standard applies to all financial statements with accounting periods ending on or after 23 December 1998.

The most fundamental change proposed in FRS 10 is that purchased goodwill and intangible assets (assuming that they can be measured sufficiently reliably for recognition) should be treated as assets in the balance sheet.[4] While this treatment was optional with SSAP 22, the majority of companies opted for the "preferred" method of immediate write-off to reserves. This classification of purchased goodwill as an asset is consistent with the generally accepted accounting practice in most other European countries, Japan, the United States and with IAS 22, the international accounting standard on business combinations. In addition, a number of econometric studies using US data have shown that the book value of a company corresponds more closely to its market value when purchased goodwill is treated as an asset and is amortised systematically over its useful life. In other words, the market (in the US) tends to view purchased goodwill as an asset when valuing a company. If similar studies were carried out using US data, a corresponding finding would probably be the result. It is appropriate, therefore, to abandon the write-off to reserves method of accounting for purchased goodwill.

The procedures for amortising purchased goodwill in the new standard are complex and controversial. The requirements for amortisation depend on the nature of goodwill and the main elements are as follows :

where the asset is believed to have a useful economic life of 20 years or less, it should be amortised over its useful economic life;

where the asset is believed to have a useful life in excess of 20 years but not an indefinite life, it should be amortised over its useful life and annual impairment reviews should be performed;

where it is considered that the assets has an indefinite life, it should not be amortised but an annual impairment review should be carried out.[5]

The impairment review is carried out in accordance with FRS 11 : *Impairment of Fixed Assets and Goodwill*. This involves comparing the amount at which purchased goodwill is stated in the balance sheet with its recoverable amount (i.e. its value to the business).

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[2] SSAP 22, paragraph 41.

[3] c.f. Tonkin, DJ and Skerratt, LCL, ed., *Financial Reporting 1992-1993 : A Survey of UK Reporting Practice*, (London : ICAEW, 1993), 203 *et seq*.

[4] FRS 10, paragraphs 7–10.

The most controversial element of these proposals is the calculation of the recoverable amount in the case of purchased goodwill. This will be necessary in cases where the useful life of purchased goodwill is expected to be greater than 20 years. It involves the calculation of the present value of future cash flows expected to be generated by purchased goodwill. This is to be achieved by dividing the company into income-generating units, estimating the future cash flows of each unit, discounting the estimated future cash flows to calculate the present value of each unit and then comparing the present value of the unit with the carrying values of its constituent assets and liabilities. To the extent that the carrying value of the income-generating unit exceeds its value in use, the unit is impaired. Concerns have been expressed regarding these amortisation proposals for the following reasons :

The proposals give management considerable latitude in establishing a recoverable amount for purchased goodwill. Discounting calculations are extremely sensitive to changes in discount percentages and changes in the estimates of future cash flows. It is conceivable that these calculation will be manipulated in order to produce the most favourable valuation from the company's perspective;
The figures used in discounting calculations are subjective and are very difficult to verify objectively. This could pose some difficulty for auditors;

The proposals are at variance with the accounting treatment in most other European countries, Japan and the US where a systematic approach is taken.

A questionable concept in the accounting standard is the notion that purchased goodwill may have an indefinite life and does not have to be amortised on a systematic basis. This proposal is at variance with the standard accounting practice for purchased goodwill in most other European countries, Japan, the US and with the international standard IAS 22 where goodwill has a finite life of between 5 and 40 years.[6] More importantly, econometric studies on the value of goodwill seem to support the fact that goodwill has a finite life. Using US data (where purchased goodwill has a maximum life of 40 years), researcher have found that for some companies, reported goodwill overstates economic goodwill; for many others, reported goodwill understates economic goodwill. On balance, it was not possible to reject the hypothesis that the goodwill asset is given an equal valuation weighting to other assets. Therefore, it seems appropriate to have a finite life of approximately 40 years for purchased goodwill.

A feature of the current standard is that the inconsistency of accounting treatment between companies which acquire intangible assets externally and those that develop them internally remains. Intangible assets procured through take-over activity are considered capable of recognition while those generated from within the organisation are not. However, in many cases, expenditure on internal intangible assets

[5] FRS 10, paragraphs 15-17.
[6] The accounting standard in the US permits a maximum useful life for goodwill of 40 years. IAS 22 permits a maximum amortisation period of 20 years.

such as Research and Development and advertising is as easily identifiable as the cost incurred during a take-over and the benefits to be achieved from such expenditure no less certain than those of purchased intangibles.

Another feature of FRS 10 is the valuation of intangible assets, a valuation which, owing to the nature of the asset, is an arbitrary one. It is impossible in most cases to separate the value of a brand from that of the rest of the business. Any valid assessment of a brand’s future profitability involves many inherently subjective judgements about marketing factors such as competitive market position, overall market prospects and the quality and value of marketing support. In short, most valuations of intangible assets will be subjective in nature and will not be liable to objective verification, a feature which may pose some problems for auditors.