Business Combinations and Goodwill

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Accounting for business combinations and goodwill are two of the most controversial topics in accounting. Throughout the years businesses and accounting standard setting bodies have continually debated the proper treatment of these accounting methods. As a result, numerous revisions have been made to the accounting standards in relation to business combinations and goodwill. These issues became very prominent during the end of the 1960’s.

During the end of the 1960’s there was a record number of mergers and acquisitions in Corporate America. As a result the Accounting Principles Board (APB), the former authoritative body of the American Institute of Certified Public Accountants (AICPA), issued Opinions no. 16 and 17 during 1970. These opinions addressed accounting for business combinations and intangibles.

APB Opinion no. 16, *Business Combinations*, specifies that there are two methods of accounting for an acquisition, which include “purchase” and “pooling-of-interests”. The proper method to be used is based upon specific criteria. If the criteria are met than the pooling-of-interests method must be used, if otherwise the purchase method must be used. Under the pooling-of-interests method it is assumed that the companies are combing their resources together rather than having one company acquire the other. This method results to the newly merged organization reporting the book value of the assets and liabilities, which were carried over during the pooling of the two companies. Under the purchase method, however, it is assumed that one company acquires another company. During an acquisition the acquired company’s assets must be restated to fair market value, which often times differs from the book value. Quite often the purchase
price will exceed the fair market value of the net assets received during an acquisition. This residual asset is known as goodwill, and it is the difference between the purchase price and the sum of the fair value of net assets (Ronald, Elsea, and Lilly, 2000).

APB Opinion no. 17, *Intangible Assets*, specifies that goodwill must be amortized over a 40-year period. A long life such as this minimizes the amount of amortization that companies must expense. As a result of expensing goodwill on an annual basis, the value of goodwill eventually disappears.

The APB issued Opinions no. 16 and 17 after intense lobbying by the government and businesses across the United States. Many of these entities had mixed feelings about the accounting method of pooling-of-interests and the requirement to amortize goodwill over a defined useful life. Such concerns were voiced to the nation’s press, which heavily criticized the APB. Many businesses and financial institutions lobbied the Securities Exchange Commission (SEC) as well as Congress. The Big Eight firms also had mixed feelings on these issues and were pressured by their audit clients (Zeff, 2005). Shortly after a final vote was taken on an Opinion for *Business Combinations* and *Intangible Assets*, one of the Big Eight firms changed its mind on the vote. As a result of this controversy the APB had to issue two separate Opinions in order to reach a majority on both topics.

Accounting for business acquisitions and goodwill continued to be controversial topics, especially during the 1990’s. During this time the US economy experienced an emergence of many service and technology-based industries. Industries such as these had a large proportion of intangible items such as research-in-progress and intellectual capital. As a result, accounting for business acquisitions of these firms was problematic
due to the fact that the excess purchase price could be identifiable specifically to research-in-progress, intellectual capital and other intangible items. Intangibles such as these are normally expensed as costs rather than capitalized as assets. An acquiring company therefore could argue that the excess purchase price should be expensed rather than capitalized as goodwill (Ronald, Elsea, and Lilly, 2000). This problem lead to inconsistencies in financial reporting since there were multiple interpretations on how to treat the excess of purchase price. As a result of this lack of comparability, the Financial Accounting Standards Board (FASB) and the SEC became quite concerned.

FASB began to reevaluate APB Opinion No. 16 and 17 during August 1996. The FASB felt that a newer approach was needed in order to provide financial statement users more relevant and reliable information in relation to goodwill. In 1999, FASB released the first of several Exposure Drafts, which dealt with business combinations and intangible assets. In the first draft FASB considered eliminating the pooling-of-interests method and suggested reducing the maximum life for amortizing goodwill to 20 years. These proposals, particularly the amortization of goodwill requirements, angered many businesses and financial institutions. Many companies were against amortizing goodwill since it periodically lowered their earnings. As a result, companies persuaded Congress to intervene and convince FASB to require an annual impairment test for goodwill rather than amortization. In March 2001, FASB issued a second exposure draft, which proposed the elimination of amortizing goodwill, which was eventually reflected in SFAS 142.

which changed the requirements for mergers, acquisitions and goodwill. Under SFAS 141, FASB mandated that the pooling-of-interests method could no longer be used. Companies therefore could only use the purchase method for business acquisitions, which requires companies to report all acquired intangibles. This was a drastic change in accounting methodology and represented a victory for FASB since the practice of pooling-of-interests was seen as a controversial method.

SFAS 142 specifies that goodwill must be recognized as an asset and included as a separate item on the balance sheet. Under SFAS 142, companies are required to do an annual impairment test for goodwill rather than periodically amortize it. Companies are required to follow a two-step process in order to test for goodwill impairment. Standards Codification 350-20-35-4 states “The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit (operating segment) with its carrying amount, including goodwill” (FASB). Standards Codification 350-20-35-8 states that “if the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss, if any” (FASB). Standards Codification 350-20-35-11 states that “If the carrying amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess. The loss recognized cannot exceed the carrying amount of goodwill” (FASB).

It is important to note that SFAS 142 states that there are instances when impairment testing has to be done on an interim basis. Standards Codification 350-10-65-2 states “Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce
the fair value of a reporting unit below its carrying amount” (FASB). Examples of events such as these include “a significant adverse change in legal factors or in the business climate”, “an adverse action or assessment by a regulator”, “unanticipated competition” and “a loss of key personnel” (FASB). Today it is very common for businesses to test impairment on an interim basis due to current economic crisis.

Even after the adoption of SFAS 142, goodwill has remained a controversial topic. Currently many nonpublic companies have criticized the complexity and cost of performing goodwill impairment tests. It has been argued that it is very difficult to assess the fair market value of reporting units because the value has to be based upon assumptions of “market multipliers, discount rates, and the amount and timing of future cash flows” (Burkholder, 2011). Such items are subject to great uncertainty because of today’s poor economic conditions. Also many companies rely on outside experts to properly assess valuations. This places a great financial burden on companies due to the amount of fees that must be paid to outside experts. On April 22, 2011, FASB issued an Exposure Draft, which addressed the issue of complexity and cost to test goodwill for impairment. Under the Exposure Draft, FASB called for a new approach to goodwill impairment assessments, which does not require entities to calculate the fair value of a reporting unit. With this new approach companies are permitted to qualitatively assess “whether the fair value of a reporting unit is less than its carrying amount” (Zyla, 2011). If it is determined “that it is more likely than not that the fair value of the reporting unit is less than the carrying value, then the entity must perform step one of the goodwill impairment test” (Zyla, 2011). If the qualitative factors indicate that it is more likely than not that the fair value of the reporting unit is not less than the carrying value, then the
entity does not have to perform additional testing (Zyla, 2011). If the proposed update is approved, the qualitative approach to goodwill impairment testing will be effective for companies covering fiscal years starting after December 15, 2011, with early adoption permitted (Zyla, 2011).

It has been over forty years since the APB issued Opinion no. 16, *Business Combinations*, and Opinion no. 17, *Intangible Assets*. Since then, the accounting standards of business combinations and goodwill have been heavily debated topics, particularly the GAAP treatment of these accounting methods. FASB attempted to resolve these issues when they issued Statement no. 141, *Accounting for Business Combinations*, and Statement no.142, *Accounting for Goodwill and Intangible Assets* during 2001. Criticisms over the accounting methodology of business combinations and goodwill, however, remained even after FASB issued these Statements. As a result FASB is currently in the process of making amendments to SFAS 142. Will these revisions resolve the ongoing issues of business combinations and goodwill? We will have to wait and see.
WORKS CITED


