ACCOUNTING FOR GOODWILL: A CRITICAL EVALUATION

by

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SUMMARY

The principal goal of this research study was to critically evaluate the current accounting treatment of purchased goodwill in terms of a theoretical framework established, including an evaluation of the true nature of goodwill.

The main conclusion of this study is that goodwill is an intangible asset representing various intangible factors contributing to the enterprise's earning capacity and providing returns in excess of a normal return on assets employed for which an acquiring enterprise is willing to pay an amount in excess of the fair value of the identifiable net assets acquired.

The cost of purchased goodwill is measured as the difference between the total purchase price and the fair value of the net assets acquired after ensuring that all assets, tangible and intangible, had been properly identified. Purchased goodwill should be amortised over the estimated period that the enterprise is expected to benefit from the acquisition of the goodwill.

Title of dissertation:
ACCOUNTING FOR GOODWILL: A CRITICAL EVALUATION

Key terms:
Accounting for goodwill; goodwill; intangible assets; purchased goodwill; inherent goodwill; negative goodwill; goodwill amortisation; business combinations; goodwill on consolidation; goodwill measurement; goodwill valuation; super profits concept; residuum concept; intangibles concept.

DECLARATION

I declare that **ACCOUNTING FOR GOODWILL: A CRITICAL EVALUATION** is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND TO THE STUDY

For many years accounting for goodwill has been one of the more controversial issues confronting the accounting profession. An increase in the number of acquisitions and mergers, coupled with the increasing amounts paid for goodwill, have brought the goodwill problem to the debating forum once again, perhaps now more than ever before. Davis (1992:76) cited the fact that a far larger component of companies' acquisition price comprises goodwill than when the American standard on business combinations regulating goodwill was approved in 1970, as one of the factors necessitating an overhaul of the accounting treatment of goodwill in the United States.

In a recent newspaper article it was also reported that in current mergers and acquisitions in South Africa, often more than eighty percent of the bid price constitutes goodwill, a figure that a decade or so ago was nearer to ten percent.

The International Accounting Standards Committee also fairly recently, in 1993, issued a revised statement on business combinations restricting the accounting treatment of goodwill to one method, namely the capitalisation and amortisation method. This led to the United Kingdom, who still allows a choice of two conflicting methods of accounting treatment of goodwill, since issuing two discussion papers on the appropriate treatment of goodwill and other intangibles in an attempt to harmonise British and international standards on goodwill.

As official accounting standards on goodwill are conspicuously absent in South Africa, it was felt that the goodwill debate needed to be reopened to bring South African goodwill practices in line with the international accounting environment.

1.2 PROBLEM DEFINITION

Since the earliest writings on goodwill, as far back as 1884, accountants, lawyers and others have tried to define goodwill, explain what the nature of goodwill is and suggested methods for treating goodwill in the accounts of undertakings. Agreement as to the true nature of goodwill seems to be one of the main stumbling blocks in achieving consensus as to the most appropriate accounting treatment of purchased goodwill. Hughes (1982), in the preface to his book Goodwill in Accounting: A history of the issues and problems, even stated that "The origin of goodwill can be revealed through history, but its nature is a matter of personal interpretation." This statement, however, underlines the basic error that many of the authors of accounting literature appears to make; trying to interpret the nature of goodwill from a personal viewpoint instead of from a theoretical viewpoint. Another mistake made by various authors was to try and define goodwill in terms of its value and not in terms of its substance. In numerous definitions one will find that the definition starts with: "Goodwill is defined as the difference between..." indicating the difference between two values whereas goodwill should really be defined in terms of its substance, i.e. the properties that constitute goodwill.

Most, if not all, of the methods of treating goodwill in the annual financial statements of entities have been criticized in one way or another as being arbitrary because the nature of goodwill is nebulous, its value is uncertain and the estimated useful life of goodwill cannot be calculated with substantial accuracy. Nelson (1953:491) even felt that goodwill "...is about as fickle as the human nature of which it is an aspect."

A further problem concerning the goodwill debate, which is really due to the disagreement as to its nature, is whether purchased goodwill should be recognised as an asset in the financial statements, and if so, whether it should be amortised in any way. Lee (1971:324), for example considers the description 'goodwill' not an asset in its own right but rather the properties constituting goodwill. Chambers (1966:218) argued that "Goodwill is not an asset of the firm, being neither severable nor measurable." Eiteman (1971:47), on the other hand, declared that "Goodwill and related intangibles are valid capital assets of economic significance to the usual business enterprise; they attach themselves intrinsically to business operations and are a valuable part of the economic worth of a going concern."

Questions in the goodwill debate for which answers should be sought are:

(a) what is the true nature of goodwill, i.e what constitutes goodwill?

(b) are the properties that constitutes goodwill such that goodwill can be classified as an asset or not?

(c) if goodwill is an asset, what value should be attributed to goodwill on its acquisition?

(d) if goodwill is an asset, what constitutes its useful life and how is it determined?

(e) if goodwill is an asset, should it be amortised in any way and on what basis?

(f) if goodwill is to be amortised, where should the write-off be disclosed?

(g) where and how should goodwill be disclosed in the annual financial statements?

(h) how should negative goodwill be treated?

(i) should internally generated or inherent goodwill be accounted for?

Maybe Reed K. Storey best summarised the problems relating to accounting for goodwill when he wrote the Director's Preface to **Accounting**

Research Study No. 10, Accounting for Goodwill, issued by the American Institute of Certified Public Accountants in 1968:

> "Perhaps accounting for goodwill has changed more often during the last century and has resisted longer efforts to find a lasting solution more or less acceptable to accountants, management and financial statement users than any other element reported in financial statements."

A method for avoiding the goodwill problem on consolidation has developed over the years by calling the excess of the purchase price over the net identifiable asset value of the entity acquired, a premium on acquisition. To do this is tantamount to acknowledging that the purchaser did not know why more was paid for the net assets acquired. When one company acquires another and the purchase price exceeds the net asset value of the acquired company, it can only be attributed to any or a combination of the following four factors, namely:

(a) an identifiable asset has been attributed a greater value than its book value;

(b) an amount has been paid primarily to obtain control of the entity for whatever reason;

(c) an amount has been paid for goodwill, whatever it is conceived to be; or

(d) too much has been paid for the net assets, i.e. a 'bad buy'.

Another method of avoiding goodwill is the so-called poolings-of-interests method where a new company is formed to facilitate a merger between two or more companies and shares are issued by the emerging company to the shareholders of the companies that were taken over. Under this method the assets, liabilities and shareholders' equity of the companies taken over are brought into the purchasing company's books at the amounts at which they were carried in the books of the companies being taken over and any excess of the fair value of the shares issued over the previously established book values is not recorded or accounted for. The

net effect is that goodwill is not recorded but gets charged off against the shareholders' equity in setting up the books of the emerging company.

Perhaps the only thing that most accountants do agree upon is that goodwill should be recorded at cost once that cost has been established. The method of determining the value of goodwill and the problem of what to do with goodwill once it has been recorded have been the main points of controversy over the years. Should goodwill be retained as an asset, or regarded as an asset at all, should it be written off immediately or over a period of time, against what should it be written off etc.

From a South African viewpoint the main problem is to establish a generally accepted method for the treatment of goodwill in the accounts of companies and other undertakings which is conceptually sound and in line with international standards.

The Accounting Standards Board the United Kingdom in its working paper for discussion, **Goodwill and Intangible Assets** issued in 1995, stated that purchased goodwill is an accounting anomaly as every method of accounting for goodwill results in inconsistencies with other aspects of financial reporting:

(a) if the accounting is to recognise as an asset that part of purchased goodwill considered to represent future benefits to the group, it is inconsistent with the accounting for internally generated goodwill; and

(b) if the accounting is to eliminate purchased goodwill against reserves, which would provide consistency of balance sheet treatment with internally generated goodwill, then it is inconsistent with the accounting for other components of the purchase transaction that are recognised as assets or liabilities (ASB, 1995:5).

Although the accuracy of this statement can and will be disputed, it high-

lights the problems and misconceptions about goodwill that exist.

Accounting for goodwill, from an asset valuation perspective, presented difficulties over the years mainly because of the fact that solutions to the goodwill problem were sought in the context of an imperfect income model, namely the historical cost income model. Perhaps, if a more theoretically acceptable income model based on proper asset valuations in terms of current values is used, the problem of accounting for goodwill may become less cumbersome.

1.3 IMPORTANCE OF THE RESEARCH

Accounting for goodwill is one aspect of the accounting field on which there is more disagreement and therefore more diverse accounting treatment than most other topics. Different countries have tried to regulate the different accounting treatments of goodwill by way of statements of generally accepted or standard accounting practice but not a single method that is generally accepted by all concerned has emerged. The United Kingdom, for instance, has issued no less than nine different discussion papers, exposure drafts and statements of standard accounting practice on accounting for goodwill over a period of sixteen years from 1980 to 1995 and to date no single method of accounting for goodwill in Britain has been generally accepted by all.

South Africa is one of the few countries that does not have a statement of generally accepted accounting practice dealing with the appropriate treatment of goodwill. A discussion paper on accounting for goodwill was issued in 1982 but has since been withdrawn and as yet no official statement of generally accepted accounting practice has emerged. All the other major countries like the United States of America, the United Kingdom, Australia and New Zealand have issued statements dealing with goodwill or business combinations or at least dealing with intangibles. All

these statements with its different methods of dealing with goodwill, however, confirms this lack of uniformity.

Internationally there is also a lack of uniformity in that, to date, no international accounting statement specifically dealing with accounting for goodwill has yet been published. The only international guideline on accounting for goodwill can be found in International Accounting Standard **IAS22 - Business Combinations**, originally issued in 1983 and revised in 1993.

Because goodwill is such a controversial concept it is essential that some kind of guideline be set for its appropriate treatment in the South African context to try and establish uniformity, or at least a reasonable degree of uniformity, in the treatment of goodwill in the annual financial statements of companies. Uniformity which is an essential element for comparison purposes, locally as well as internationally. Especially in this phase of the internationalisation of South African companies, it is important that South African companies' accounting treatment of a phenomenon like goodwill is in harmony with its international competitors.

The South African Institute of Chartered Accountants also has accounting for goodwill as an unresolved research topic and would welcome research relating to this topic.

1.4 SCOPE OF THE RESEARCH

This research study is limited to a critical evaluation of the prevailing accounting treatment of goodwill as well as a critical evaluation of statements and pronouncements on accounting for goodwill in South Africa, the United Kingdom, the United States of America, Canada, Australia and New Zealand. As part of the study the true nature of goodwill will also be critically examined.

Because of its current use, the problem of accounting for goodwill is addressed in the context of the historical cost income model and financial statements prepared based on that model. Limited attempts will be made to explain goodwill in terms of other non-conventional income models such as the current cost income model, the net realisable value model and the present value income model.

Although this research study distinguishes between purchased goodwill and internally generated goodwill, or inherent goodwill, the study concentrates on purchased goodwill either through direct business combinations or goodwill on consolidation. Any reference to goodwill in the main body of this study hence refers to purchased goodwill unless otherwise stated. Inherent goodwill will only be addressed to a limited extent.

This research study thus covers both the treatment of goodwill resulting from the merger of companies in the case of the acquisition of net assets as well as the result of the acquisition of shares in another company, i.e. goodwill on consolidation.

1.5 RESEARCH METHODOLOGY

This research study is primarily a literature study. The information for the literature study will be obtained mainly from text books, journals of professional accounting bodies, guidelines and statements of generally accepted accounting practice of various accounting bodies as well as from manuals.

1.6 FORMULATION OF HYPOTHESIS

When a research problem has been identified, the problem is normally analyzed by formulating a hypothesis (Ryan, Scapens & Theobald, 1992: 99). As this research study is however restricted to descriptive research,

where the formulation of a hypothesis is not normally done, it was decided not to set a hypothesis.

1.7 PROGRAM OF THE STUDY

This study comprises six chapters which are divided as follows:

Chapter 1: Introduction

In this chapter the background to the study is described. The definition of the problem is given, the importance of the research is emphasised, the scope of the study is defined, the research methodology used is described, the reason for not stating a hypothesis is given and the program of the study is enumerated.

Chapter 2: Theoretical background

The theoretical framework within which the problem of accounting for goodwill can be critically evaluated will be established in this chapter. The development of accounting theory relating to goodwill will be described, including the definition and functions of a theory and theory development. The theory approach to be used in establishing a theory framework for goodwill will also be set. In the discussion on the theoretical framework for goodwill, the true nature of goodwill will be discussed including a discussion whether goodwill can be regarded as an asset or not. This will be followed by a discussion on the measurement and valuation of goodwill. Goodwill will also be evaluated in terms of the conceptual framework for financial reporting to determine whether goodwill can rightfully be included in the financial statements as an asset. This chapter will be concluded with a discussion on the treatment of negative goodwill as well as a limited discussion on internally generated goodwill.

Chapter 3: Development of the goodwill concept

In this chapter the historical development of the goodwill concept will be described, going back to the early legal definitions of goodwill. This section mainly concentrates on the different conceptions of goodwill: the super profits concept, the residuum concept and the intangible resources concept. This chapter will be concluded with a description of the historical development of the actual accounting treatment of goodwill.

Chapter 4: Current status of International Accounting Standards on Goodwill and its development

The current status of accounting statements and pronouncements of all the major accounting bodies worldwide as well as its development will be described in this chapter. The countries whose accounting statements will be analyzed are: The United States of America, Canada, the United Kingdom, Australia, New Zealand and South Africa. A brief description of the accounting practices concerning goodwill in the European Community will also be given. The statement relating to business combinations of the International Accounting Standards Committee will also be explained in terms of its reference to goodwill.

Chapter 5: Analysis of current methods of accounting for goodwill

In this chapter the different methods of accounting for goodwill will be described and critically evaluated in terms of the theoretical framework for goodwill established in chapter 2. The methods that will be evaluated are: (a) maintaining goodwill as a permanent asset until its value has been permanently impaired; (b) writing goodwill off to reserves at the date of acquisition; (c) treating goodwill neither as an asset or a direct write-off against reserves but rather than a deduction off shareholders equity (dangling debit); (d) capitalising goodwill and amortising it over its

estimated useful life; and (e) writing goodwill off share premium account.

Chapter 6: Summary and conclusions

The preceding chapters will be summarised in this chapter and the conclusions and recommendations of this study will also be presented. Areas needing further research will also be proposed at the conclusion of this chapter.

1.8 SOURCE REFERENCES

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CHAPTER 2

THEORETICAL FRAMEWORK

2.1 INTRODUCTION

Any study of an accounting problem cannot be done unless it is done within the confinements of a sound theoretical framework. To be able to come to some logical conclusion regarding the true nature and appropriate accounting treatment of goodwill, any critical evaluation of current accounting practice regarding accounting for goodwill should be based on sound theoretical principles.

Accounting for goodwill is one of the most contentious accounting problems that has eluded a common solution for more than one hundred years. It is also a problem that is unlikely to be solved unless there is an all-embracing conceptual theoretical framework that includes the proper identification of the nature of goodwill as well as the problem of the valuation of goodwill, both purchased and self-developed. Accounting practices for goodwill are at present supported by a wide variety of concepts and conventions born from decades of accounting practices rather than an all-embracing conceptual framework (Tollington, 1995:49).

2.2 DEVELOPMENT OF ACCOUNTING THEORY RELATING TO GOODWILL

When a study is made of a field of knowledge like accountancy and more specific a sub-problem of accountancy like accounting for goodwill, it is necessary to look at the fundamental nature of the specific phenomenon and to focus on the theory behind the phenomenon and not on the prevailing accounting practice, since such practices are not necessarily logical expressions of theory. To study the theory of a field of knowledge

commands an inquiry into its fundamental nature, to deal with its substance as opposed to its form and to focus on concepts rather than applications (Salmonson, 1969:1). Yu (1976:1) states that any discipline, like accounting, needs a foundation upon which it can rest and a conceptual framework within which it can explain and predict the specified class of events. Yu defines a discipline as "... a branch of systematized learning, governed by a set of formalized rules regulating the process of knowledge acquisition." and further concludes that accounting, by nature, falls into this definition of a discipline.

It should, however, be noted that a single theory will not hold true for all times. Yu (1976:10) states that no theory that is derived from human experience, like accountancy, can be unassailably proven or certain and that a particular theory is accepted as valid in the absence of a better theory. Hendriksen (1982:1) also states that all theories are subject to modification or abandonment with the development of new theories.

To establish a theoretical framework for goodwill, a closer look should be taken at the definition of a theory in general and the process of theory construction as well as accounting theory in particular.

2.2.1 Definition of theory

Various definitions of a theory exist in the literature and only a few will be looked at, particularly those by authors of publications on accounting theory.

Yu (1976:11) states that theory is expressed in terms of a set of propositions which are logically consistent and of which some have been tested, verified or confirmed.

Harvey & Keer (1978:2) defines a theory as "...a body of knowledge in

the form of a set of relationships that explain an observed phenomenon."

Most (1982:55) defines a theory as "...a systematic statement of the rules or principles which underlie or govern a set of phenomena." According to him, a theory may be viewed as a framework permitting the organization of ideas, the explanation of phenomena, and the prediction of future behaviour.

Kerlinger defines a theory as "...a set of interrelated constructs, definitions and propositions that present a systematic view of phenomena by specifying relations among variables with the purpose of explaining and predicting the phenomena." (Belkaoui, 1985:10).

According to Hendriksen (1982:1), the most appropriate definition of theory as it applies to accounting is that theory represents "... the coherent set of hypothetical, conceptual and pragmatic principles forming the general frame of reference for a field of enquiry." This definition is almost identical to the one that appears in the American Accounting Association's (AAA) 1966 publication, **A Statement of Basic Accounting Theory, (ASOBAT),** which defined theory as "...a cohesive set of hypothetical, conceptual, and pragmatic principles forming a general frame of reference for a field of study." (AAA, 1966:1)

From the definitions above it can thus be concluded that a theory primarily consists of a systematic system of rules and principles that forms a general framework within which the various phenomena of a discipline are explained and which can be used to predict future behaviour of the phenomena.

2.2.2 Functions of a theory

From the definitions of a theory it seems then that two of the main func-

tions of a theory is its explanatory function and its predictive function. Yu (1976:1) states that all disciplines are mostly empirical in nature and an empirical discipline is one that deals with a specific class of phenomena in terms of *explanation* and *prediction*. Harvey & Keer (1978:8) suggest that the essence of a theory is the *explanation* of observed phenomena and that a measure of its success may be found in its ability to *predict* future events. Wolk, Francis & Tearney (1989:3) states that theory helps to *explain* and *predict* phenomena that exist in a given field and accounting is no exception.

As regards the explanatory capability of a theory, most authors agree that one of the main functions of a theory is to explain the occurrence of certain phenomena in practice. Chambers (1966:6) suggests that in the process of theory construction, certain observations of events or operations are made and that these observations needs explanation. Harvey & Keer (1978:2), Most (1982:55), Hendriksen (1982:1) and Belkaoui (1985:10) all support the suggestion that a theory should explain an observed phenomenon.

As regards the predictive capability of a theory, there are some differences of opinion amongst authors of accounting literature. Belkaoui (1985:10) suggests that an accounting theory should explain and predict accounting phenomena and when such phenomena occur, they should be seen as verification of the theory. Hendriksen (1982:1) states that: "The primary test of a theory, however, is its ability to explain or predict." He, however, qualifies his statement by acknowledging that predictability is a relative term, being improved gradually with the development of better theories and the development of better methods of applying the theories operationally and that the ability to predict is not the only consideration in the development of theories in accounting (Hendriksen, 1982:2). Most (1982:55) is more outspoken and states that: "A theory is above all an explanation. There is a widespread misconception that a theory must aid

in prediction, but not all theories do."

This disagreement on the predictive capability of a theory is largely due to the difference between the social sciences and natural sciences. As Wolk et al. (1989:40) correctly commented that accounting, and other social sciences like economics, cannot be expected to be as precise in its measurement and predictions as the natural sciences.

Other functions or uses of theories listed by Salmonson (1969:15) include (1) the proving why one practice is superior to another; (2) justifying a particular approach in a given circumstance and (3) providing definitions.

If the functions of a theory is then related to accounting theory it can be concluded that the main functions of accounting theory would be that a theory explains or describes accounting practice, while it may or may not predict future accounting behaviour.

2.2.3 Methodology of theory development

What then is the link between accounting theory and accounting practice? Should the development of a theory of a certain accounting phenomenon like goodwill be based on, or derived from existing accounting practice, using inductive reasoning, which relies on the drawing of generalized conclusions from detailed observations and measurements? Or should it rather be derived from a sound theoretical base using deductive reasoning, which is the process of starting with objectives and postulates and from these deriving logical principles that provide the bases for practical applications? It is rather obvious that current accounting practice regarding goodwill is so controversial that it can ill afford to serve as a basis for accounting theory.

Wolk et al. (1989:35) classifies theories, besides the inductive or deductive approaches, into normative and descriptive theories. Normative theories employ value judgements and tend to be prescriptive i.e. prescribing the way things ought to be done while descriptive theories attempt to establish existing relationships between phenomena. Here, it seems, that it is not an either/or situation but that normative and descriptive theories can compliment each other. Various theorists like Tinker, Merino & Neimark (1982) and Christenson (1983) questioned whether descriptive theories based on empirical research can really be free from bias because implicit value judgements underlie the form and content of the research itself (Wolk et al. 1989:35).

Glautier & Underdown (1976:25) also distinguishes between a descriptive theory and a normative theory. Relating it to accounting theory they state that a theory which attempts to explain *how* financial information is collected, analyzed and communicated is called a descriptive accounting theory while a theory which attempts to state *what* financial information should be collected, analyzed and communicated is called a normative theory. Thus a descriptive theory describes what is and a normative theory is concerned with what ought to be.

Henderson, Peirson & Brown (1992:8) also distinguishes between descriptive theories, which is concerned with the relationship between variables in the real world, and prescriptive theories which normally propose a course of action and is usually identified by the words "ought" and "should". They also refer to the two methodologies in theory development namely the scientific method, which relies upon observation of the 'real world', and the analytical method where the development of the theory is not concerned with the 'real world' but relies on logical arguments to reach conclusions (Henderson et al., 1992:4).

Taking the above methodologies as well as the array of goodwill prac-

tices into account, it seems that the problem of constructing a theoretical framework for accounting for goodwill should be solved by using the normative or prescriptive method. Thus trying to establish theoretically how goodwill ought to be treated based on its underlying nature.

The normative or prescriptive method, where a theory is developed based on sound logical reasoning going from premises to conclusions, is largely based on deductive reasoning. Hendriksen (1982:7) observes, however, that any formal theory that can be tested and verified must include both elements of inductive and deductive reasoning. This view is echoed by Wolk et al. (1989:37) who state that the inductive/deductive approaches are far from being either/or competitive approaches but that deduction and induction are complimentary in nature and are often used together. Harvey & Keer (1978:11) feels that whether inductive or deductive reasoning is used is of lesser importance than the ultimate match between the two.

2.2.4 Definition of accounting theory

As already stated, the main functions of accounting theory should be the explanation or description of accounting practice, while it may or may not predict future accounting behaviour.

According to Hendriksen (1982:1), accounting theory can be defined as "...logical reasoning in the form of a set of broad principles that (1) provide a general frame of reference by which accounting practice can be evaluated and (2) guide the development of new practices and procedures." Most (1982:55) defines accounting theory as "...that branch of accounting which consists of the systematic statement of principles and methodology, as distinct from practice." Evanston states that accounting theory consists of a set of conceptual and pragmatic propositions explaining and guiding the accountant's action in identifying, measuring and

communicating economic information (Salmonson, 1969:1).

Most authors of accounting literature agree that there is no single accounting theory but rather a set of theories and sub-theories. Hendriksen (1982:1) states that, although a single theory of accounting may be desirable, the best that could be accomplished at that stage was a set of theories or models that may be complimenting or competing. Most (1982: 1) is of the opinion that there is no generally accepted theory of accounting but rather a number of accounting theories and some theories of accounting. Belkaoui (1985:1) feels that there is no comprehensive theory of accounting but rather a different number of theories arising from the use of different approaches to the construction of an accounting theory or from attempts to develop theories of a middle range rather than one single comprehensive theory. The American Accounting Association (1977:2) states that "...there exists in the financial literature not *a theory* of financial accounting but a *collection of theories* which can be arrayed over the differences in user-environment specifications." What must however be stressed is that theory cannot be divorced from the practice it purports to underlie, explain or attempt to predict.

The most important goal of an accounting theory would then be to provide a coherent set of logical principles and rules that provide a general frame of reference for the development and evaluation of theoretically sound accounting practices (Hendriksen, 1982:1).

2.2.5 Levels of accounting theories

In the construction of the language of a specialised concept it can be approached on three levels namely the syntactical level, which is concerned with the relationship between signs, symbols, or concepts; the semantical level, which is the process of developing signs or symbols as representations of real world phenomena; and the pragmatic level which is

concerned with the responses of individuals to sign or symbols presented to them (Penman, 1973:202).

Using these three levels, Hendriksen (1982:2) classifies accounting theories into three main prediction levels namely:

(a) syntactical theories which attempt to explain current accounting practices and predict how accountants would react to certain situations. These theories relate to the structure of the data collection process and financial reporting;

(b) interpretational or semantical theories which concentrate on the relationship between a phenomenon and the term or symbol it represents; and

(c) behavioural or pragmatic theories which emphasise the behavioural or decision-oriented effects of accounting reports and statements.

Using Hendriksen's classification of prediction levels of accounting theory, accounting for intangibles, assuming for the moment that goodwill is an intangible, can be approached using all three levels. At the syntactical level it is suggested that intangibles should be matched with associated revenues whenever possible or that intangibles should be carried forward, only to be matched if a direct link could be established between the intangible and income revenue. On the interpretational or the semantic level, intangibles should be carried as assets as they represent future economic benefits and must only be written off once those future economic benefits can no longer be expected to be received. At the behavioural or pragmatic level, the emphasis should be on the reporting of possible inputs into decision models of investors and creditors or on information for share markets (Hendriksen, 1982:399).

2.2.6 Theory Approach

In trying to evaluate the goodwill problem it will be necessary to utilise

a normative approach which normally follows deductive reasoning and this is the approach that will be followed in attempting to establish a theoretical framework for goodwill. Having said this, it does not exclude the use of some inductive reasoning and a limited descriptive approach especially when looking at current accounting standards and practices. The evaluation of accounting for goodwill will also be approached using all three prediction levels of theory. At the structural level, the capitalization of goodwill as an asset and its amortisation over its estimated useful life, or the immediate write-off of goodwill will be evaluated. At the interpretational level the carrying of goodwill as a permanent asset and the writing off of goodwill only in the case of a permanent diminution in its value will be evaluated. On the behavioural level the disclosure of goodwill in the annual financial statement will be evaluated.

2.3 A THEORETICAL ACCOUNTING FRAMEWORK FOR GOODWILL

Accounting for goodwill has probably presented more problems from a theoretical viewpoint than any other accounting subject. Everingham & Hopkins (1982, Service 24, 1994:228) feels that the major reason for the lack of a generally accepted accounting treatment of goodwill is the inability of the accounting profession to agree on the underlying nature of goodwill. Hendriksen (1982:399) suggests that the reasons are a lack of certainty regarding its value and the estimation of its useful life. Glautier & Underdown (1976:171) suggests that goodwill is a controversial topic due to its vague nature and the difficulty in arriving at a value that is verifiable. Hughes (1982:4) feels that much of the variation in the accounting treatment of goodwill is due directly to problems associated with defining the nature of goodwill.

It seems logical then that, in trying to establish a theoretical framework for goodwill which can be used in the critical evaluation of any method for accounting for goodwill, the true nature of goodwill should first of all

be examined, i.e. it should be ascertained what constitutes goodwill.

In the past, certain attempts to define the nature of goodwill was unsuccessful due to the fact that the true nature of goodwill was overlooked and goodwill was defined in terms of its value and not in terms of its substance. Authors like Gynther (1969), Weinwurm (1971) and Tearney (1973), who claim that the individual intangible components comprising goodwill should be separately identified and valued, have, by virtue of their reasoning, explained the true nature of goodwill the best.

2.3.1 The nature of goodwill

2.3.1.1 Introduction

As mentioned above, in the process of trying to establish what the nature of goodwill is, the mistake of confusing the nature of goodwill with the measurement or the valuation of goodwill should not be made. Gynther (1969:247) had the following comment regarding the goodwill problem:

> "The main cause of the arguments seem to be that the real nature of goodwill has been submerged in the literature by the methods that we have been forced to use in practice when calculating the total values of entities..."

The true nature of goodwill lies not in a value but in some kind of intangible factor or factors which causes goodwill to have a value.

2.3.1.2 Major conceptions of goodwill

Hendriksen (1982:407) distinguishes three major conceptions of goodwill from an accounting point of view, namely:

(a) the valuation of intangible attitudes towards the firm;

(b) the present discounted value of the excess of expected future pro-

fits over that considered a normal return on the total investment excluding goodwill; the so-called super-profits approach; and

(c) the excess of the value of the business as a whole over the valuation of its individual tangible and intangible assets; the so-called master valuation account approach or the residuum approach.

Most (1982:380), similar to Hendriksen with the exception of the intangible attitude approach, also distinguishes three meanings of the word goodwill as it is generally used in relation to accounting, namely:

(a) a theoretical construct meaning the present value of expected future profits in excess of a normal return on investment;

(b) an empirical observation meaning the excess of the price paid for a business over the fair market value of its net assets excluding goodwill; and

(c) an accounting technicality meaning the excess, on consolidation, of the amount paid by the holding company for its share of the net assets of a subsidiary.

The biggest proponent of the so-called super-profits approach was P.D. Leake. In his 1914 article in The Accountant he deviated from the traditional customer relations approach to goodwill when he defined goodwill in terms of expected future super profits (Leake, 1914:82).

The main advocate of the so-called master valuation account approach to goodwill was J.B. Canning in his 1929 book, The Economics of Accountancy, in which he defined goodwill in terms of a master valuation account in which he included all intangible factors incapable of separate valuation as well as the aggregate of the future items of future income included in the asset schedule (Gynther, 1969:249).

Both these conceptions of goodwill, however, have more to do with the measurement and valuation of goodwill as to the nature of goodwill itself.

Stewart (1980:10), in discussing the future excess profits concept and the residuum concept of goodwill, concluded that both these concepts are directed not so much to the nature of goodwill, but to its measurement. Like Young observed in 1981, purchased goodwill *arises* when one business acquires another as a going concern, the value of goodwill can be *established* at a specific point in time by a definite market transaction and goodwill is *measured* by the difference between the purchase price paid and the fair value of the net identifiable assets acquired (Young, 1981:19).

When a payment has been made for goodwill, it is also important to ensure that the payment was in fact for goodwill and not for something else. In determining the nature of goodwill one should start with a basic question, namely: why would one company be willing to expend more than the fair value of the identifiable assets of another company?. The answer, surely, must be that that company possesses some quality or qualities which the purchasing company seeks to acquire. Having said this, what is also true is that the mere fact that an amount was paid in excess of the net asset value of a company does not necessarily constitute goodwill. Eiteman (1971:49) concluded that everything that is labelled goodwill in financial reports is not always goodwill and that frequently the term 'goodwill' is often used to describe the total excess of purchased cost over book value of assets acquired with little reference to the underlying nature of the excess.

When the purchase price exceeds the net asset value of an enterprise this excess can be attributed to any, or a combination, of the following factors, namely:

(a) an identifiable asset has been attributed a greater value than its book value. In that case the asset should be recorded at its revalued or fair value;

(b) an amount has been paid primarily to obtain control of the entity or

some facet of the entity and this can be for various reasons, for example, to eliminate competition, to obtain specific expertise etc. Tearney (1973:43) states that it is in fact not uncommon for one company to pay a premium to acquire an unprofitable company to obtain, for example, the services of that company's research and development personnel. Instone (1990:79) contends that a purchasing company may acquire a subsidiary for more than its net book value for reasons wholly unrelated to goodwill;

(c) simply too much has been paid for the net assets. In other words a 'bad buy' resulting in a 'loss' for the purchasing company. Devine (1985:93) put it appropriately as follows:

> "The reasons why the purchase price is above the current value of the assets may be numerous; for example, the difference may be due to stupidity on the buyer's side or shrewdness on the part of the seller. (If stupidity is evident, immediate write-off as a loss is required...)"

Alex Young (1981:20), The Institute of Chartered Accountants in England and Wales's then Technical Director, also commented on this as follows:

> "If an excessive sum has been paid for an investment, management should be persuaded to recognise the loss as soon as possible and every effort should be made to ensure that goodwill is not used as a burying ground for management's mistakes and losses.";

(d) an amount has been paid for 'goodwill', whatever it is conceived to be.

Similarly, if the net asset value exceeds the purchase price, the difference can be due to:

(a) an identifiable asset being attributed a lesser value than its book value. In that case the asset should be recorded at its revalued value;

(b) the purchaser expecting inadequate profits or even losses in the

purchased business; and/or

(c) the fact that the net assets had been purchased at a bargain price and this 'gain' should be recognised. This is usually referred to as 'negative goodwill' or 'discount on acquisition.' This question of 'negative goodwill' will be discussed later in this chapter.

In a study undertaken by Arnold et al. in 1992 they attempted to break down goodwill into its components and came up with the following three components, namely:

(a) the fair value of separately identifiable intangible assets;
(b) the present value of benefits arising, not reflected in (a) above, from jointness in activities and market imperfections such as monopoly position and barriers to entry; and
(c) over- or underpayment.

They concluded that (a) and (b) should be capitalised as representing future benefits from which a future income stream would be expected, and subsequently amortised. Over- or underpayments should be written off to profit and loss account immediately (Gowthorpe, 1993:36). Their conclusions are fairly accurate, the only criticism being that they refer to the individual components of goodwill in terms of a value instead of in terms of the actual assets it really consists of.

From the above it follows then that when an amount has been paid in excess of the net asset value of a firm, the excess should first be analyzed as to whether all assets have been fairly valued, whether any amount has been paid to obtain control of a company for whatever reason, or whether any amount has been paid in excess of, or below a fair price for the business as a whole, before goodwill comes into play.

The assets and liabilities that have been acquired and to which fair values must be ascribed, should also not be restricted to the assets and liabilities

carried in the accounts of the purchased company. A thorough investigation should be carried out to determine what assets have actually been acquired and what liabilities have been assumed as intangible assets developed by the company may not appear on the company's books as they have not been purchased, but may have definite fair values (Holgate, 1985:6).

2.3.1.3 Goodwill and the earning capacity of a business

What then are those factors resulting in the fact that a buyer is willing to pay a price in excess of the fair value of the net assets acquired and does it have any relationship with the earning capacity of a business?

As the main objective of a firm, at least in a free market environment, is to make a profit and preferably an above average profit, it can be reasonable to assume that, under normal circumstances, in the process of acquiring another company, the payment for goodwill has something to do with the profit earning capacity of the purchased company.

Literature on accounting for goodwill shows considerable support for the theory that goodwill consists of various intangible factors contributing to the enterprise's above average earnings capacity. Paul-Joseph Esquerre, as far back as 1915, in his book, <u>The Applied Theory of Accounts</u>, stated that the goodwill of corporations differs from the goodwill of sole proprietors in that the goodwill of corporations represents the earning power of an established business whose products will sell, no matter who offers them for sale (Esquerre, 1915:245). Lee, (1973:178) states that goodwill has a generally accepted relationship with profitability in the sense that the higher business profits are, the more likely that goodwill exists in the business. Holgate (1985:4) argues that the value of a business is normally determined based on its earning power and that earnings and future earnings are determined by or derived from a variety of factors, some of

which are not normally reflected on a balance sheet.

George T. Walker (1953:213) had the following to say about goodwill and its relationship with the earning capacity of the firm:

> "By definition, goodwill has no accounting significance except in terms of an earning capacity which is estimated to be above normal. A price is paid for goodwill - a price above the value placed on the other assets - because profits in excess of a normal return on the investment is anticipated. In other words, an enterprise is purchased, not primarily as a means of securing a group of assets, but as a means of securing a stream of income in the future."

Tearney (1973:43) states that "...when one entity acquires another and willingly incurs a cost greater than the fair market value of the other's net identifiable assets, the latter company possesses some characteristics important to the acquiring company." He concludes that these characteristics that are combined to create goodwill are usually of an intangible nature like personnel skills, distribution channels, product diversification etc. According to him, goodwill then represents a payment made by one entity to acquire another entity's profitability (Tearney, 1973:41).

Leonard Spaceck (1964:36), in discussing the true nature of goodwill, points out that goodwill relate to or arise from countless factors and circumstances such as the public acceptance of the company's products, the composition and skills of management, public relations, or the strength of a research organisation. He concludes that goodwill is the valuation placed on the earning power of a going concern as a whole over the amounts paid for the net assets necessary to produce, market, sell and administer its products and services. Goodwill, therefore, is the present value placed on anticipated future earnings in excess of a reasonable return on these producing assets.

Weinwurm (1971:32) argues that goodwill is comprised of items that

contribute to the profitability of the firm but cannot be expressed or converted into quantitative, monetary data which are the only ones that are recognised by the accounting system. These are resources of a business that are relatively more difficult to quantify, for example harmonious labour relations. He concludes that the most important factor as part of goodwill is the contribution of individuals to the company's profits and thus goodwill comprises the value of these human contributions (Weinwurm, 1971:33).

Glautier & Underdown (1976:171) describes goodwill as the aggregate of those intangible attributes of a business which contribute to its success, like favourable location, a good reputation, the ability and skill of its workers and management and its good relations with creditors, suppliers and customers. Gynther (1969:247) states that goodwill exists because assets are present even though not listed with tangible assets. He gives examples like special skills and knowledge, high managerial ability, monopolistic situation, social and business connections good name and reputation, favourable situation, excellent staff, trade names and established clientele.

Gilbert (1972:193) argues that the excess price over the net book value that remains unallocated is usually paid because the buyer anticipates that these assets purchased will earn profits which are greater than normal for the industry. Using this argument, goodwill is then a payment for these excess profits. He further concludes that these excess earnings are a result of past factors such as skills of management, public relations, advertising, public acceptance of the company's products and the favourable attitude towards the firm by its customers, suppliers, employees and the general public.

Hinton (1973:31) feels that the earning-power concept of goodwill recognises that there are various intangible factors contributing to unusual

earnings and that such factors, although capable of separate identification, can only be valued as a group. Hughes (1982:177) regards goodwill as the differential ability of one business, in comparison with another or an assumed average firm, to make a profit and that its presence is indicated by better than average profits.

Stewart (1980:10) attributes the existence of goodwill to certain advantageous factors, conditions and resources that are present, even though they are not listed with the tangible assets. He lists special skills and knowledge, high managerial ability, monopolistic situation, social and business connections, good name and reputation, favourable situation, excellent staff and established clientele as assets in this category.

The Canadian Institute of Chartered Accountants considers goodwill to be a combination of all the factors which cannot be individually identified and which contribute to, or accompany the earnings capacity of a company (CICA 1580:par.54). **AASB 1013,** the Australian statement on accounting for goodwill, regards the nature of goodwill as being the future benefits from unidentifiable assets which, because of their nature, are not normally individually brought to account. Examples of unidentifiable assets include market penetration, effective advertising, good labour relations and a superior management and operating team (AASB 1013,1988).

Discussion Paper 3, (DP3), of the Accounting Practices Committee, (APC), of the South African Institute of Chartered Accountants, although since withdrawn, supported the notion that goodwill pertains to that part of the value of a business which arises from all those advantageous circumstances which generate earnings in excess of the aggregate of that which might be expected to accrue from an uncoordinated investment in the individual assets. These circumstances include, inter alia, an effective management team, strong sales or advertising organisation, advantageous location, established customers etc.

Catlett & Olson, in **Accounting Research Study No. 10, (ARS10),** listed various advantageous factors that, according to them, could give rise to superior earning power of a company. These include items such as superior management team; outstanding sales manager or organisation; effective adverting; secret manufacturing process; good labour relations; outstanding credit rating; strategic location; favourable tax conditions and favourable government regulations.

In a recent research study done by Chauvin and Hirschey in 1994 amongst 2,693 American firms reporting goodwill during the period 1989 to 1991, in which they examined the economic association between goodwill, profitability and the market value of a firm, they proved that expenditures by companies on advertising and research and development in improving the quality of the companies' products, had a positive influence on the value of goodwill. They also proved that goodwill can be tied to a firms ability to generate above normal earnings (Chauvin & Hirschey, 1994:178).

Hendriksen, on the other hand, argues that the notion that goodwill comprises certain intangible attributes not reported in the financial statements, is incorrect. He argues that most of these attributes attach to other tangible and intangible assets and should not be seen separately from them. He uses the example of a favourable location and he argues that this, a favourable location, only means that the land and buildings is worth more than similar property elsewhere. He admits that items such as good management and monopolistic privileges do not attach to specific assets but to the business as a whole (Hendriksen, 1982:408). Hendriksen's view, however, will only hold true if, after all these intangible and tangible assets have been revalued, no amount has been paid for 'goodwill'.

In all of the above arguments one will find the reasoning that the payment

for goodwill represents either a payment for intangible factors causing earnings above a normal return i.e. the capacity to earn above normal earnings (Walker, Tearney, Weinwurm, Gynther, Hughes etc.), or a payment for these abnormal earnings itself (Spaceck, Gilbert etc.). Those arguing that the payment for goodwill represents a payment for excess future earnings, however base their argument on the fact that these excess future earnings are caused by various intangible factors present in the business.

From the above it can thus be concluded that there is enough support for the theory that goodwill consists of various intangible factors whose existence in an undertaking is closely linked to the firm's ability to generate above average profits and returns and that, in the process of another company purchasing this company, it is willing to pay an amount in excess of the fair value of the net identifiable assets of this company for these intangible factors causing these above average profits and returns.

2.3.1.4 Characteristics of goodwill

In the analysis of the nature of goodwill it is also important to look at the distinguishing characteristics of goodwill. From the available literature the following characteristics have often been attributed to goodwill, namely:

(a) goodwill is intangible, intrinsic to the company and cannot be sold separately from the business as a whole;

(b) the value of goodwill has no reliable or predictable relationship to any costs which may have been incurred by the business;

(c) individual intangible factors which may contribute to goodwill is difficult to identify and, if identified, cannot be valued separately;

(d) the value of goodwill is highly volatile and may fluctuate widely according to internal and external circumstances over relatively short periods of time; and

(e) the valuation of goodwill is highly subjective as its value may differ

from one valuer to another.

As regards goodwill being inseparable from the business, this characteristic is endorsed by Holgate (1985:4): "Goodwill, by its very nature, relates to an enterprise as a whole and cannot be sold separately from the business as a whole."; Chambers (1966;209): "Now, first, the goodwill of a firm or a division of a firm is not severable from that firm or that division."; Hughes (1982:177): "In an economic sense, goodwill has virtually no meaning apart from business enterprise..."; Catlett & Olson, (1968:21): "Goodwill ... is an inseparable part of a business and cannot be sold separately from a business or from a clearly delineated part of a business."; Weygandt, Kieso & Kell (1990:449): "Goodwill is therefore unusual because unlike other assets...goodwill can be identified only with the business as a whole." and many more.

Hughes (1982:188) questioned the view that the value of intangibles, like goodwill, bears no definite relation to the costs of their development. He believes that the size of the firm and its financial resources determine its ability to plan and fit customer demand and therefore goodwill. The larger the firm, the easier it is, through large financial expenditure, to maintain the firm's differential advantage relative to its competitors.

According to Hinton (1973:32) all of the various intangible factors contributing to the value of goodwill, are not individually capable of the type of measurement that can be applied to resources whose values exist apart from the business as a whole and that no valid bases exist for allocating costs to these intangible factors. Tearney (1973:45), on the other hand, argues that valuation techniques have been developed to such an extent that all assets acquired in a business, regardless of how intangible they may be and whether or not they appear on the balance sheet, should be identified, valued and disclosed thereby eliminating the need for an item called goodwill. He is an opponent of the method where goodwill is

determined by the method of valuing all identifiable assets and whatever is left over of the purchase price, must be goodwill. Weinwurm (1971:34) is another proponent of the view that the individual components of goodwill can be valued separately and amortised in accordance with the circumstances of each of these components. In 1969, Gynther also concluded that rapid advances are being made in probability theory, sensitivity analysis, subjective probability and simulation techniques so that these techniques will, in the not distant future, make direct valuation of assets, including goodwill, possible with a higher degree of precision than at present (Gynther, 1969:255). These suggestions, although describing the true nature of goodwill, are however very impractical due to the fact that the various factors making up goodwill are interrelated and dependant on their interaction with each other and can therefore not be individually valued. Catlett & Olson (1968:12) insisted that none of the attributes comprising goodwill is able to be measured in the same way as the other separable resources and property rights of a business which exist apart from the business as a whole.

The notion that the value of goodwill is volatile is stated in **Statement of Standard Accounting Practice No. 22, (SSAP22)**, and **Exposure Draft No. 47, (ED47)**, where it is felt that the value of goodwill may fluctuate widely according to internal and external circumstances over relatively short periods of time and is thus constantly changing. Gilbert (1972:195) also feels that, due to its volatility, goodwill evaporates rapidly and must constantly be replaced if a company is to keep ahead of its competitors. Spaceck observes that the determination of the value of goodwill at any time is immediately obsolete because the value placed on goodwill by one investor has only a momentary life because it can be replaced by the valuation placed on goodwill by another investor based on changed conditions. He concludes that the value of goodwill is like the weather - whatever its value is, becomes history a moment later when it changes (Catlett & Olson, 1968:157). Hughes (1982:191) observes that, although in-

stability of its value is particularly true of goodwill, it is also not exclusive to goodwill but that instability of value is a characteristic of any asset.

Catlett & Olson (1968:21) listed the following two additional, but controversial, characteristics as being characteristics of goodwill:

(a) goodwill is not utilised or consumed in the production of earnings; and

(b) goodwill appears to be an element of value which runs directly to the investor or owner of a business and not to the business itself.

Catlett & Olson's view that goodwill is not utilised or consumed in the production of income is not shared by everyone, especially those who favours the amortisation of goodwill. Rutteman (1987:32) states that "...the price paid for another company is dependant on the perceived value of the intangible asset of goodwill, that the intangible asset represents a cost used up in earning additional profits, and that the cost (amortisation) and the profits should both be reflected in earnings per share."

Catlett & Olson based their reasoning regarding the ownership of goodwill on the reasoning of Raymond Chambers in his book, Accounting, Evaluation and Economic Behaviour. Chambers (1966:211) contends that the goodwill of a going concern belongs to the constituents and not to the firm. He believes that it is the owners or shareholders of a firm who place a value on goodwill and it is they who have the right to sell the business as a going concern or sell their interest in the business. Their view is also supported by Spaceck who believes that goodwill value reflects a state of mind of the investor based on his expectations or anticipation (Stewart 1980:14). Catlett & Olson's view is attacked by Lee (1971:322) on two grounds namely:

(a) it ignores the various resources contributing to the existence of goodwill and therefor to the overall profitability of the firm; and

(b) it confuses the nature of goodwill with the method of valuing it. He also pointed out that, if their argument holds true for goodwill it should hold true for all the other assets of the business and that the business then, by definition, would possess no assets at all as all assets should be deducted off shareholders' equity. Reed Storey also criticised Catlett & Olson's viewpoint on the basis that Chamber's arguments are based on another accounting system, namely the continuously contemporary accounting system, whereas Catlett & Olson argues from within the historical cost accounting system (Catlett & Olson, 1968:164).

2.3.1.5 Critical evaluation of goodwill as an asset

If the nature of goodwill is to be properly understood it is absolutely vital to establish whether goodwill is an asset of the business or not as this will ultimately determine its proper treatment. To be able to determine whether an accounting item like goodwill is an asset or not, a closer look should be taken at the nature of assets in general and intangible assets in particular.

William Paton, in his 1922 book, Accounting Theory, was probably the first author of accounting literature to attempt to define an asset when he stated:

> "...what are the assets? What is meant by the term 'properties'? In brief, a property is any consideration, material or otherwise, owned by a specific enterprise and of value to that enterprise." (Paton, 1922,30).

Canning, in his 1929 book, The Economics of Accountancy, was one of the first authors to give a fairly comprehensive definition of an asset. (Hendriksen 1982:251). He defined an asset as follows:

> "An asset is any future service in money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or equitably secured to some persons

> or sets of persons. Such a service is an asset only to that person or sets of persons to whom it runs."

In 1962, Sprouse and Moonitz, in **Accounting Research Study No. 3, A Tentative Set of Broad Accounting Principles for Business Enterprises, (ARS3),** defined assets as "...expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction." (Sprouse & Moonitz, 1962:8)

Hermanson (1964:4), in a research paper on accounting for human assets, defined assets as "...scarce resources, operating within the entity, capable of being transferred by forces in the economy, and expressible in terms of money; which have been acquired as a result of some current or past transaction and which have the apparent ability to render future economic benefits."

In 1965, Paul Grady, in **Accounting Research Study No. 7, Inventory of General Accepted Accounting Principles for Business Enterprises, (ARS7),** defined assets as "...something with a debit balance...on the basis that it represents either a property right or value acquired, or an expenditure made which has created a property right or is properly applicable to the future." (Grady, 1965:227).

The Financial Accounting Standards Board (FASB) in the United States currently defines assets in its conceptual framework publication, **Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements, (SFAC6),** as "...probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." (Most, 1882:344). Most however feels that it would be more correct to define an asset as the right to future economic benefits, rather than the future economic benefits themselves.

Statement AC000, **Framework for the Preparation and Presentation of Financial Statements, (AC000)**, of the South African Institute of Chartered Accountants and the statement of the International Accounting Standards Committee (IASC) of the same name, defines an asset as follows:

> "An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise."

Paragraph 53. of AC000 further states that:

> "The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise."

Hendriksen (1982:251) lists the following four characteristics as being critical in the evaluation whether an item is an asset:

(a) there should exist some specific right to expected future benefits or service potentials;

(b) the right must accrue to the enterprise who claims the asset;

(c) there must be a legally enforceable claim to the rights and services or some other evidence that receipt of the future benefits is probable; and

(d) the future economic benefits must be a result of past transactions.

Everingham & Hopkins (1982, Service 17, 1991:6-9) list three basic characteristics of an asset namely:

(a) it contains a probable or expected future benefit which may flow to the enterprise by being:

 (i) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;

 (ii) exchanged for other assets; or

 (iii) used to settle a liability.

(b) the enterprise can obtain the benefit and control other's access to it; and

(c) it arises from a past transaction or event.

These requirements differs from Hendriksen's requirements on one aspect namely the requirement that there must be a legally enforceable claim to the rights and services. The definitions of an asset by the FASB, the IASC and AC000 do not make legal title to an economic resource a requirement for the latter to be able to be recognised as an asset, thus permitting certain leased resources to be shown as assets by the lessees (Everingham & Hopkins, 1982, Service 17, 1991:6-8).

There appears to be a number of additional features attributed to assets such as physical form, severability and exchangeability which help to identify assets but which are not essential for an item to be classified an asset.

As regards physical form, William Paton, in his official comments on ARS10, stated that one of the common mistakes we all make is attaching too much importance to the molecular conception of an asset. He stated that an asset is an economic quantum which may be attached to or be represented by some physical object or it may be not (Catlett & Olson, 1968:143).

The characteristics of exchangeability and severability are used as essential characteristics of assets by Chambers (1966:103) to support his theory that all assets must be able to be converted to other means by exchange or the process of production or by donation. He also used his definition of an asset to claim that goodwill is therefore not an asset of the firm as it does not possess the characteristic of severability (Chambers, 1966: 209). Wolk et al. (1989: 302) feel that the severability and exchangeability approach to the definition of an asset is very conservative and seems to restrict unnecessarily those items that should be included in the balance sheet as assets.

From the above it can be concluded then that, for an item to be classified as an asset, it should contain at least the following three characteristics, namely: it (an asset) must (1) have an expected future economic benefit (2) controlled by the enterprise (3) resulting from a past transaction. For goodwill to be able to be classified as an asset it should therefore comply to these three basic requirements.

From the discussions earlier in this chapter, there seems to be general support for the fact that a payment for goodwill ultimately represents a payment for expected future excess profits. As was earlier stated, goodwill is an inseparable part of an enterprise and therefore goodwill is, by its inseparable nature, under the full control of an enterprise. Goodwill is always the result of a past transaction or event. Purchased goodwill arises from the acquisition by one company of another company either by direct purchase of assets or by business combinations involving the acquisition of shares. Inherent goodwill, as will be discussed later, are also the result of past transactions in the sense that it arises from expenditures on the part of the enterprise.

It can thus be concluded that goodwill is an asset as it complies to the three basic requirements of an asset namely the future benefits requirement, the requirement of control by the enterprise and the requirement of resulting from a past transaction or event.

The contention that goodwill is an asset is supported by most authors of accounting literature. Emery (1951:560) argues that, as an asset is viewed as an unallocated cost, representing the present value of anticipated future services, goodwill, from this point of view, is definitely an asset assuming a payment has been made for it. This view is echoed by Young (1981:19). Stewart (1980:14) concludes that if goodwill is seen to represent certain intangible resources, then goodwill should be accounted for as an asset because purchased goodwill represents an invest-

ment in such intangible assets. This view is also supported by Macintosh (1974:31) who claims that goodwill is correctly accounted for as an asset as it represents an investment in a group of intangible assets such as special skills and knowledge, high managerial ability etc. Notable other authors that also support the notion that goodwill is an asset are Leake (1914), Paton (1922), Walker (1938), Nelson (1953) and Lee (1971). The major authors contending that goodwill is not an asset to the business are Spaceck (1964), Chambers (1966) and Catlett & Olson (1968). Although they admit that goodwill is an asset, they argue that it does not belong to the company but to its shareholders.

The contention that goodwill is an asset is also fully supported by the following professional accounting bodies: the American Institute of Certified Public Accountants, the Canadian Institute of Chartered Accountants, the Institute of Chartered Accountants in Australia, the Australian Society of Certified Practising Accountants, the New Zealand Society of Accountants and the International Accountants Standards Committee. The only point of difference of these professional bodies is regarding the valuation of goodwill i.e. how goodwill should be treated once acquired.

Goodwill also complies to the definition of an intangible asset. Kohler's Dictionary for Accountants defines an intangible asset as a capital asset which has no physical existence and which value is limited by the right and future benefits that possession confers on the owner (Cooper & Ijiri, 1983:267). Goodwill, by its nature, complies to this definition of an intangible asset as it is an asset which has no physical existence and represents future economic benefits to its owner. Kohler's Dictionary in fact states that intangible assets may include goodwill acquired in a purchase of a business. **Accounting Principles Board Opinion No. 17 (APB17)** also identifies goodwill as the most common intangible asset.

It is thus also the contention of this study that goodwill is an intangible

asset as its basic components are various other intangible assets.

2.3.1.6 Conclusion

Too often in the past the true nature of goodwill was overshadowed by methods to recognise, measure and value goodwill or simply because goodwill was used as some kind of 'rubbish bin' in which the excess of the purchase price over the net assets acquired was dumped without analysing the excess to ascertain why the excess was paid.

It is contended then that the true nature of goodwill lies not in a value as is often the case with many attempts to define its nature, but with the various intangible factors comprising goodwill.

The true nature of goodwill can thus be summarised as follows:

> *Goodwill is an intangible asset, inseparable from the business as a whole, representing various intangible factors contributing to the enterprise's earning capacity and providing returns in excess of a normal return on assets employed, for which an acquiring enterprise is willing to pay an amount in excess of the fair value of the identifiable net assets acquired. These intangible factors differs from one enterprise to another but can include items such as a superior management team, harmonious labour relations, favourable location, unique production process, a good business reputation, established clientele etc.*

Goodwill, therefore, is an asset that should be recorded at its cost to the purchaser at the date of acquisition. The question of its subsequent treatment, i.e. its retainment as an asset on the balance sheet, its immediate write-off or its amortisation over its estimated useful life will be discussed

in Chapter 5.

2.3.2 The measurement and valuation of Goodwill

2.3.2.1 Introduction

Having concluded that goodwill is an asset, albeit intangible, the next step in the problem of accounting for goodwill is the measurement and valuation of goodwill. Measurement in accounting has over the years meant the assignment of numerical values to objects, such as assets, and activities, such as turnover and expenses, related to a business entity in such a way that they can be aggregated or disaggregated as required by specific circumstances (Hendriksen (1982:75).

Jensen, Coffman & Burns (1980:3) refers to accounting measurement as the rules and standards that direct the determination of income and the valuation of assets in basic financial statements prepared under generally accepted accounting principles while measurement is defined by Wolk et al. (1989:10) as the assignment of numbers to the attributes or properties of objects being measured. AC000 points out that measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement.

According to Hendriksen, (1982:257), valuation in accounting is the process of assigning meaningful quantitative monetary amounts to assets. Most (1982:235) uses the terms valuation of assets and measurement of income and points out the difference between the two being that assets are valued and income is measured. For the purposes of attributing a value to goodwill the term valuation will be used.

The measurement process in accounting is however not an exact science

but rather a social science. Like other social sciences accounting concepts do not rest on universal truths or general laws, which results in value judgements being applied to the interpretation of economic and social events. The subjective nature of these value judgements implies that the measurement process in accounting cannot be exact which obviously will result in controversy as to the measurement process. (Glautier & Underdown, 1976:7).

2.3.2.2 Valuation bases

AC000 (par. 100) identifies four valuation or measurement bases namely historical cost, where assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of acquisition; current cost, where assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired (or replaced) currently; realisable value, where assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal; and present value, where assets are carried at the present discounted value of the future cash inflows that the item is expected to generate in the normal course of business.

The problem of the valuation of goodwill under the current cost basis is that asset values, based on replacement cost, effectively excludes goodwill because of its inseparable identity. Apart from the fact that the replacement cost of purchased goodwill are subjectively determined, internally generated goodwill also cannot be valued using the replacement cost basis because of the difficulty of giving it an objective measurement (Stewart, 1980: 24). The net realisable value basis also poses a problem for the valuation of goodwill on the basis of its inseparability and also, assuming goodwill could be sold separately, the lack of a selling market for goodwill. The present value basis requires assets to be valued at the

present value of future cash flows and creating these cash flows and deciding on the appropriate discount rate is highly subjective and poses the problem of the continual revision and updating of the value of goodwill due to changing circumstances (Tollington, 1994:44).

This leaves the historical cost basis and, as AC000 states, historical cost is still the most commonly used valuation basis. Accounting for the cost of purchased goodwill, being the acquisition cost of an asset at a specific point in time, should, for the time being at least, be based on historical costs within the traditional historical cost income model.

2.3.2.3 Goodwill within the historical cost income model

As, at present, only purchased goodwill is recorded in the books of a company, the most appropriate valuation basis that should be used is the historical cost basis. Under the historical cost convention, the cost of goodwill is normally measured as the difference between the price paid (or cost) and the fair values of the net assets acquired or, alternatively, the difference between the value of the business as a whole and the fair values of its net separate identifiable assets acquired. Fair values being defined as the amounts that would be agreed upon by informed parties dealing at arm's length in an open and unrestricted market.

Accounting Principles Board Opinion No. 16, (APB16), states that the basis for the measuring the cost of an asset has no effect on its subsequent treatment and gives the following guidelines regarding the application of the historical cost basis of accounting to the acquisition of assets, depending on the nature of the transaction:

(a) assets acquired for cash or exchanging other assets should be recorded at cost i.e. the amount of cash disbursed or the fair value of other assets distributed;

(b) assets acquired by incurring liabilities should be recorded at cost

i.e. the present value of the amounts to be paid; and

(c) assets acquired by issuing shares of the purchasing company should be recorded at the fair values of the assets acquired i.e. at the fair values of the consideration received (Accountants International Study Group (AISG), 1975).

Hendriksen (1982:264) states that, in terms of historical costs, assets are generally recorded on the basis of the exchange prices at which the acquisition transaction took place. "Cost is thus the economic sacrifice expressed in monetary terms required to obtain a specific asset or a group of assets."

The APB16 guidelines when assets are acquired in a business combination can be summarised as follows:

(a) identifiable assets acquired and liabilities assumed should be allocated a portion of the cost of the acquired business, usually equal to the fair values of the acquired assets at the date of acquisition; and

(b) the excess of the cost of the acquired business over the sum of the amounts allocated to the identifiable assets acquired less liabilities taken over, should be allocated to purchased goodwill (AISG, 1975).

The main problem in the valuation of goodwill under the historical cost basis, however, is the question of its subsequent treatment, i.e. whether goodwill should be retained at its original recorded cost, written off immediately after acquisition or amortised over its estimated useful life.

The permanent retention of goodwill as an asset at its original acquisition cost is advocated by those who feel that goodwill has an indefinite life and do not depreciate but is in fact maintained through current expenditure. Those in favour of the direct writing off of goodwill to reserves are

of the opinion that goodwill is a disbursement of resources in anticipation of future earnings while those advocating amortisation feels that the goodwill acquired does in fact have a limited life and that the amortisation costs should be matched with the associated excess revenue resulting from the acquired goodwill.

2.3.2.4 Conclusion

As goodwill is an asset it should be recognised as such in the accounts of a company at its acquired cost. This cost should be measured as the difference between the total purchase price and the fair value of the net assets acquired after ensuring that all assets, both tangible and intangible, have been identified thereby assuring that the balance of the purchase price represents pure purchased goodwill as defined earlier.

2.3.3 Goodwill within the conceptual framework for financial reporting

As accounting for goodwill is a valuation problem effecting financial reporting one should also consider accounting for goodwill within the conceptual accounting framework for financial reporting. The FASB defines a conceptual framework as "...a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function and limits of financial accounting and reporting." (Everingham & Hopkins, 1982, Service 17, 1991:5).

Due to the variety of definitions of the elements of financial statements i.e. assets, liabilities, equity, income and expenses, the IASC issued a policy document called Framework for the Preparation and Presentation of Financial Statements with the objective of, inter alia, narrowing the number of permissable alternative accounting treatments in accounting (Everingham & Hopkins, 1982, Service 17, 1991:5). The Accounting Practices Board in South Africa, (APB), issued AC000, of the same name,

in 1990 in response to the IASC's document and the local statement is in totality the same as the international standard.

In AC000 four qualitative characteristics of financial statements are identified namely understandability, relevance, reliability and comparability.

With understandability is meant that the financial statements must be readily understandable by its users. With relevance is meant that information must be relevant to the decision-making needs of the users. The relevance of information is affected by its nature and materiality. With reliability is meant that information contained in the financial statements must be reliable, free from material error and bias and can be depended upon to represent faithfully that which it purports to represent or could reasonably be expected to represent. Reliability also covers the concepts of neutrality, prudence and substance over form. With comparability is meant that users of financial statements should be able to compare these statements with statements of the same firm over time in order to identify trends in its financial position and performance as well as being able to compare the financial statements of different companies in order to evaluate their relative financial position and performance. (AC000, par. 24 to 42).

AC000 (par. 82-83) also gives criteria for an element to be recognised in the financial statements, either in the income statement or the balance sheet. For an item to meet the definition of an element to be recognised in the financial statements of a company it should have:

(a) the probability of any future economic benefit associated with the item flowing to or from the business; and
(b) a cost or value that can be measured with reliability.

Capitalising goodwill and either retaining it as an asset or amortising it over its expected useful life satisfies most of the qualitative characteris-

tics set out in AC000. Provided the accounting policy regarding goodwill is properly disclosed, the users of financial statements fully understand what is meant by purchased goodwill. Goodwill is also relevant to the users as it discloses the actual goodwill acquired in a business combination. Disclosing goodwill on a consistent basis also complies to the comparability characteristic since the company's performance can be compared with previous years' performance. An argument has been put forward that by capitalising purchased goodwill but not inherent goodwill does in fact not allow for intercompany comparisons but this argument should not be used for not capitalising purchased goodwill but rather for the recognition of inherent goodwill. As regards reliability of the goodwill figure, the main objection to amortisation is the arbitrary figure for the amortisation period flowing from the uncertainties of the expected useful life of goodwill. If, however, the intangible factors constituting goodwill is properly identified, the life of goodwill will be able to be calculated with much more accuracy and reliability.

As regards recognition in the first place, goodwill represents the probability of future economic benefits flowing to the business and its cost or value can be measured with reliability being the acquisition cost at a particular point in time namely the date of acquisition.

It can thus be concluded that purchased goodwill can, taking the requirements of AC000 into account, be rightfully included in the financial statements.

2.3.4 Negative goodwill

During the study of the literature it was noticeable how many authors ignored the concept of so-called 'negative goodwill' where the fair values of the net assets acquired exceeds the purchase price. This could possibly be due to the fact that 'negative goodwill' does not occur very often

or in fact that 'negative goodwill' should not exist as it means that the valuation of the net assets is not correct. It is however a fact that it does happen, for reasons not of the concern of the buyer, that the seller is willing to sell the net assets at a price below the fair values of the net identifiable assets and the concept of 'negative goodwill' does arise. The term 'negative goodwill' is however an unfortunate term as it, according to Woolf (1985:119) "...defies all the laws of logic and language..." Hendriksen (1982:412) argues that if goodwill is defined as representing a group of unidentifiable favourable attributes of the business that is separable from the values of the identifiable assets, it is difficult to conceive of this being negative. He further argues that if the firm is worth less than the values of the separable assets, the owners would rather dispose of these assets separately rather than as a group. Lall (1968:731) claims that in a sense every business has some form of goodwill and that the suggestion of a firm having 'negative goodwill' or 'badwill' is worse than useless.

Having also concluded that goodwill is an asset, it follows logically that it cannot have a negative value because, if it to satisfy the requirements of an asset with the emphasis on future economic benefits, the least value that can be attributed to these future economic benefits is zero. Therefore, if the value of goodwill is seen as the value of those unidentifiable intangible factors comprising goodwill, 'negative goodwill' as such cannot exist.

As has been stated earlier, if the net asset value exceeds the purchase price, the difference can be due to:

(a) an identifiable asset being attributed a lesser value than its book value;

(b) the purchaser expecting inadequate profits or even losses in the purchased business; and/or

(c) the fact that the net assets had been purchased at a bargain price.

It follows logically that in cases where so-called 'negative goodwill' do arise, the excess of the book values over the purchase price should be analyzed to ascertain why the shortfall in purchase price did arise. If it was due to identifiable assets being attributed a value lower than its book value the particular asset should be recorded at its fair value.

In the case where the purchasing company expects inadequate profits Everingham & Hopkins (1982, Service 13, 1989:235) suggests an immediate or very short period of write-off to income to adhere to the matching concept.

In the case where the net assets had been acquired at a bargain price, i.e. a value below its fair value, the net assets have effectively been acquired at a discount. The question now arises of how this discount should be treated in the accounts of the purchaser. The viewpoint of the IASC in **International Accounting Standard No. 22, (IAS22),** requires this discount to be treated in one of two ways, namely:

(a) the fair values of all non-monetary assets should be reduced proportionately until the excess is eliminated. When it is not possible to eliminate all of the excess by this method, the remaining excess should be treated as deferred income to be recognised as income on a systematic basis over a period not exceeding five years unless a longer period, not exceeding twenty years can be justified (the preferred method); or

(b) the total excess of the fair values of the net identifiable assets over the purchase price should be treated as deferred income and recognised as income on a systematic basis over a period not exceeding five years unless a longer period, not exceeding twenty years can be justified (the alternative treatment).

The logic behind this treatment is that the non-monetary assets have been acquired at a discount and should thus be recorded at cost to ad-

here to the cost principle. The total discount, spread over these non-monetary assets, will be realised as income when the assets concerned are sold or consumed. For example, in the case of fixed assets, the discount is realised through lower depreciation charges over the useful life of the asset (IAS22, 1993:par 50).

APB16 requires the excess of the value of the net assets acquired over the purchase price to be applied to reduce proportionately the values of non-current assets (excluding long term investments in marketable securities). If this allocation of the excess reduces the values of these non-current assets to zero and a balance remains, it should be classified as a deferred credit and charged systematically to income over the period estimated to be benefitted from, not exceeding forty years.

SSAP22, the United Kingdom statement on goodwill, has a different viewpoint and requires negative goodwill to be credited directly to reserves on acquisition but does not stipulate which reserve. This viewpoint is in support of the standard's preferred method of treating positive goodwill, i.e. a direct write-off against reserves. Holgate (1985:123) suggests that negative goodwill should be credited to unrealised reserves and only credited to realised reserves, such as the profit and loss account, as the assets are depreciated or realised. **Exposure draft No. 47, (ED47),** proposed that 'negative goodwill' be credited to income through the profit and loss account over an appropriate period which will normally be the average life of the fixed assets acquired. Again this was the converse of the approach suggested in ED47 for positive goodwill.

Both the Australian statement on goodwill, AASB 1013, and the New Zealand statement on business combinations, SSAP-8, require a discount on acquisition, their version of 'negative goodwill', to be applied to reduce proportionately the fair values of non-monetary assets acquired. Where these non-monetary assets have been reduced to zero, a balance

of discount remains, it should be taken to profit and loss account as a gain.

Everingham & Hopkins (1982, Service 13, 1989:234) suggest the excess be treated as a non-distributable reserve, only to be credited to income as and when the assets acquired at the date of acquisition are either disposed of or realised.

Thus, to adhere to the cost principle, it seems that it is appropriate to apply the excess of the fair values of net assets acquired proportionately to the fair values of the non-monetary assets acquired to reduce their fair values to the cost to the acquirer thus acknowledging the fact that they have been acquired at a discount. The discount so applied will be realised as and when the assets to which it applies are either disposed of or reduced through depreciation. By taking the excess discount not applied to reduce non-monetary assets to zero, to income on a systematic basis seems acceptable, thereby adhering to the prudence principle of not taking unrealised profits to income until it is realised.

The method adopted in the United Kingdom of crediting reserves, especially realised reserves, appears to contravene both the cost principle and the prudence principle. The method adopted in Australia and New Zealand of crediting the profit and loss account with the excess discount not applied to reduce the net assets acquired to cost, appears to contravene the prudence principle by taking to income unrealised gains.

2.4 INHERENT GOODWILL

It is generally accepted that most businesses are worth more than the fair values of its net assets and that this is due to internally generated goodwill in existence in the business. The expenses in generating and maintaining this internally generated goodwill is written off as operating

expenses as and when incurred. Everingham & Hopkins (1982, Service 12, 1989:229) states that most businesses would realize more as a going concern than if the net assets were sold separately. Price Waterhouse (1990), in its official response to ED47, states that: "Goodwill exists in all businesses at all times but its value reflects ever-changing economic expectations and keeping track of the individual elements of a goodwill value is difficult..." At present, in accordance with generally accepted accounting practice and within the historical cost concept, inherent or internally generated goodwill is not recorded in the financial statements of a company.

As regards inherent goodwill there are two different viewpoints. One viewpoint, which is conceptually sound, is that there is no fundamental difference in nature between inherent goodwill and purchased goodwill while the other viewpoint is that they do differ in nature.

SSAP22 (par. 5) states that there is no difference in character between purchased goodwill and non-purchased goodwill and that the only difference is that, in the case of purchased goodwill, the value is determined, albeit on a subjective basis, as a fact at a particular point in time by a market transaction while this is not true of non-purchased goodwill. Catlett & Olson (1968:88) also feel that purchased goodwill and inherent goodwill have the same characteristics and the only significant difference is that purchased goodwill relates to a business that has been acquired and that the goodwill that has been paid for, is identifiable. **Exposure Draft No. 43, (ED43),** of the Accounting Research and Standards Board in New Zealand argues that purchased goodwill can be seen as internally generated goodwill valued objectively by an arm's length transaction and that the recognition of purchased goodwill is in itself a proof of the existence of inherent goodwill.

Woolf (1985:120) on the other hand, argues that there is a fundamental

difference between purchased goodwill and inherent goodwill. According to him purchased goodwill is determined by quite different factors than inherent goodwill. He contends that a purchaser will take different factors into account when deciding to buy a company that would not apply to a company on its own which is not the subject of a purchase. He also points out that inherent goodwill is reflected implicitly in the balance sheet as a result of past economic activity while purchased goodwill, by contrast, represents the additional amount over and above the values reflected in the company's balance sheet, including inherent goodwill, which the acquiring company is willing to pay for the benefits flowing from the combination in the future. His viewpoint can be attacked on two points. Firstly, inherent goodwill is never reflected on the balance sheet and secondly, it is not the nature of inherent goodwill that differs from purchased goodwill, but the way they are accounted for (Everingham & Hopkins, 1982, Service 13, 1989:229).

According to Njeke (1991:188), some of the reasons why inherent goodwill is not recorded in the financial statements of a company are as follows:

(a) inherent goodwill is not subject to a purchase transaction, like purchased goodwill, to be able to determine a reliable market valuation of goodwill;

(b) the periodic increases and decreases in the value of inherent goodwill cannot be measured with any degree of reliability; and

(c) AC000 requires that any element recognised in the financial statements must have a cost or a value that can be measured with reliability.

Catlett & Olson (1968:68) cites the reasons for not recognising non-purchased goodwill as (a) conservatism, (b) absence of a basis for determining its value and (c) the cost basis of accounting.

ED47 claims that inherent goodwill should not be recognised and included in the balance sheet as, in a cost based accounting model, it does not pass the criteria for recognition as neither its cost nor the transaction that gives rise to its existence can be identified.

Everingham & Hopkins (1982, Service 13, 1989:229) put forward the argument that inherent goodwill is not recognised mainly due to the absence of a generally accepted objective method of measurement. They further claim that, to incorporate inherent goodwill in the balance sheet, would be an attempt to turn the balance sheet into a valuation statement, which is not the function of a balance sheet under the historic cost convention.

Young (1981:19) best summarises the current state of accounting treatment for inherent goodwill when he stated:

> "...it is recognised that inherent goodwill is present in most businesses in that as going concerns they are worth more than their fair net asset value and that the amount of inherent goodwill fluctuates constantly, unrecognised, but in general being renewed continually. No historical cost can be assigned to it, as goodwill has been built up incidentally to the general development of the business and there is no expenditure which can be directly ascribed to its creation. There is therefore no case within the framework of conventional accounting for recording inherent goodwill in the books, even in a situation where it will have a value if sold."

Chauvin and Hirschey (1994:178), however, concludes that, given the importance of goodwill as a vital determinant of business performance, accountants should consider the balance sheet recognition of internally generated goodwill. They further state that, despite the fact that inherent goodwill numbers are "inherently soft" and not based on arm's length transactions, goodwill valuations are not unique in this regard. They feel that to ignore inherent goodwill is in conflict with their findings that

goodwill can be tied to a firm's ability to generate above-normal earnings (at least in the non-manufacturing sector).

Davis (1992:78) claims that if goodwill is as important an asset as many believe, it should belong on the balance sheet regardless of its origin, whether it be purchased or internally generated, both from a fair-presentation and a full-disclosure point of view. He further states that one way of estimating internally generated goodwill is for a company to subtract the net assets' market value from the total market capitalization as it is represented by the share price of the company's shares. He admits that this is likely to understate goodwill's value as many purchasers are likely to pay a premium over the current share price but claims that the share price provides a fair evaluation of the company's goodwill as an independent entity.

It is not the intention to go much deeper into the question of inherent goodwill as it is not within the scope of this study, but the question of recognition of inherent goodwill is a matter that maybe needs a rethink. Although the non-recognition of inherent goodwill is consistent with the recognition criteria of the conceptual framework in AC000, it is inconsistent with the recognition of purchased goodwill as an asset. Some form of accounting for inherent goodwill cannot be avoided forever and although, for different reasons, Catlett & Olson (1968:89) was quite correct in stating that, without substantial differences in the character of purchased goodwill and inherent goodwill, a serious question arises as to whether two completely different bases of accounting should exist for the two classifications of goodwill - to recognise one as an asset and not the other.

2.5 SUMMARY

When concluding as to the nature of goodwill it is perhaps easier to state

what goodwill is not. Goodwill is *not* the difference between the purchase price and the fair value of the net identifiable assets; goodwill is *not* the difference between the value of an entire business and the value of its net separable resources; goodwill is *not* the present value of the expected future profits in excess of a normal return on the identifiable tangible and intangible assets excluding goodwill and goodwill is *not* the premium paid by a holding company for the shares of its consolidated subsidiaries at the date of acquisition. All the above are methods developed either to measure goodwill or to put a value on goodwill.

Goodwill is an intangible asset, inseparable from the business as a whole, representing various intangible factors contributing to the enterprise's earning capacity providing returns in excess of a normal return on assets employed, for which an acquiring enterprise is willing to pay an amount in excess of the fair value of the identifiable net assets acquired. These intangible factors differs from one enterprise to another but can include items such as a superior management team, harmonious labour relations, favourable location, unique production process, a good business reputation, established clientele etc.

When an amount has been paid in excess of the net asset value of a firm, the excess should first be analyzed as to whether all assets have been fairly valued, whether any amount has been paid to obtain control of a company for whatever reason, or whether any amount has been paid in excess of, or below a fair price for the business as a whole before any amount should be ascribed to purchased goodwill.

Where the fair value of the net assets acquired exceeds the purchase price it is contended that this constitutes a bargain purchase and that this excess should be used to proportionately reduce the fair value of the non-monetary assets to its actual cost. If the excess so applied reduces the non-monetary assets to zero and an amount of discount remains, it

should be treated as deferred income and taken to income over the period estimated to be benefitted from i.e. as and when the assets acquired are either depreciated or disposed of. The term 'negative goodwill' is an unfortunate choice and should be avoided.

The value of purchased goodwill should be measured, under the historical cost convention, as the difference between the purchase price and the fair values of the net assets acquired or, alternatively, the difference between the value of the business as a whole and the fair values of its net separate identifiable assets acquired.

As goodwill represents the probability of future economic benefits flowing to the business and its cost or value can be measured with reliability, being the acquisition cost at a particular point in time, namely the date of acquisition, goodwill can be rightfully included in the financial statements as an asset within the requirements set out in the conceptual framework for financial reporting, AC000.

At present, inherent goodwill should not be accounted for due to the absence of a generally accepted objective method of measurement under the historical cost convention, but the question of its recognition should be revisited.

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CHAPTER 3

DEVELOPMENT OF ACCOUNTING FOR GOODWILL

3.1 INTRODUCTION

When, in 1781, a certain Dr Samuel Johnson had to sell a friend's brewery he commented that: "We are not here to sell a parcel of boilers and vats but the potentiality of growing rich beyond the dreams of avarice." (Wixley, 1974:300). According to Wixley, it was unlikely that Dr Johnson gave a thought to the problem of the purchaser of recording this amount that he paid in excess of the value of the boilers and vats for this 'potentiality of unlimited riches', i.e. goodwill, and according to him that problem is still not fully resolved.

The development of the goodwill concept has gone hand in hand with the development of the business enterprise, which meant that the concept of goodwill and its attempted definition was largely affected by the form of business dominant at the time when goodwill was defined. For example, during the nineteenth century and earlier, when the dominant forms of business were the sole proprietor and the partnership, goodwill was defined in terms of the relationship between the proprietor or owners of the business and the customer, i.e. in terms of customer relations. During this period goodwill was defined in terms of the value attached to an existing business as opposed to a new business.

During the time of the rising of the corporation and the emphasis on the earnings of the business, goodwill was defined in terms of excess profits over normal profits. It was only later with the advent of the business combination that goodwill was defined in terms of the excess paid over the net assets acquired.

Attempts to define goodwill initially come from two main sources namely legal courts and authors of accounting literature. Goodwill has been discussed from a legal viewpoint from as early as 1417 (Hughes, 1982:7) when English courts battled with the legal aspects pertaining to goodwill. Early references to goodwill, in a commercial sense, occurred from as early as 1571 as is evidenced by the following extract taken from an article by P.D. Leake (1914:81) in The Accountant:

> "...the word "goodwill" has been in commercial use for centuries, as is shown by the following reference to old writers:-
>
> 1571 Wills & Inv. N.C. (Surtees 1835) 352, I gave to John Stephen .... my whole interest and good will of my Quarrel (i.e. quarry).
>
> 1766 Goldsm. Vic. W.I.V. Having given a hundred pounds for my predecessor's goodwill.
>
> 1786 Lounger No. 79, On her marriage with the knight she had sold the goodwill of her shop and warehouse.
>
> 1836 Marryat Japhet VII., The shop, fixtures, stock-in-trade, and goodwill, were all the property of our ancient antagonist.
>
> 1863 Fawcett Pol. Econ. IV., ii (1876) 536. A solicitor can either sell the good-will of his business, or leave it to his children."

3.2 HISTORICAL DEVELOPMENT OF THE GOODWILL CONCEPT

The historical development of the goodwill concept over the years will be explained from the early customer relations concept, the later future excess profits concept and the residuum concept as well as the concept of goodwill consisting of various intangible factors contributing to an undertaking's success. The historical development of the goodwill concept will also be looked at from the earliest legal definitions in England as this invariably had an impact on the first commercial usage of the term 'goodwill'.

The 4th of February 1884, it seems, heralded the first public discussion on the concept of goodwill when William Harris addressed the 16th Ordinary meeting of the Manchester Accountants' Students' Society with a paper entitled The Law and Practice in relation to Goodwill (Harris, 1884:9). This paper was later published in The Accountant of 29 March, 1884 as probably the first article on goodwill to appear in any accounting journal (Hughes, 1982:24).

In this article Harris (1884:9) defined goodwill as follows:

> "Goodwill may be defined as being the money value over and above the actual assets of a concern (such as book debts, stock-in-trade, machinery &c.) which can be realised in cases of death, dissolution, retirement or liquidation;..."

Harris based his definition of goodwill on various earlier court case decisions, particularly the case of *Churton v. Douglas* (1859).

As mentioned earlier, court case decisions had a significant influence on early accounting interpretations of goodwill and it is thus appropriate to start off with a look at these early legal definitions of goodwill.

3.2.1 Early legal definitions of goodwill

Probably the earliest legal case where goodwill was first recognized as an asset was in England in 1743 in the case of *Giblett v. Reade* (Hughes, 1982:18). However, as early as 1620, there was a case where an individual sold his wares and agreed not to compete with the purchaser. Upon violating this agreement the purchaser sued the seller and the court decided in favour of the purchaser thus, in effect, giving legal protection to 'goodwill' although it was not called goodwill at the time (Hughes, 1982: 15).

The oldest legal definition of goodwill that can be found is that of Lord

Eldon in the case *Crutwell v. Lye* in 1810, namely:

> "The goodwill which has been the subject of sale is nothing but the probability that the old customers will resort to the old place." (Lall, 1968:728).

This definition of goodwill placed the emphasis on two concepts namely the customers and the location of the old business. The business involved was that of a wagoner (Lisle, 1903:196) and it was thus almost inevitable that locality played a major role in this definition.

In 1843, in the case of *England v. Douglas*, goodwill was regarded as the chance or probability that customers would be retained at a certain place of business as a result of the way the business had been previously carried on by the previous owners (Lall, 1968:728). This definition was in essence the same as that of Lord Eldon in the 1810 case.

In the case of *Churton v. Douglas* in 1859, Vice-Chancellor Wood had this to say, referring to the earlier definition of goodwill of Lord Eldon:

> "Lord Eldon did not mean to confine the rights involved in the term goodwill to the advantage of occupying premises to which customers were in the habit of going. Goodwill must mean every advantage (affirmative advantage, if I may so express it, as contrasted with the negative advantage of the vendor not carrying on the business himself) that has been acquired by the old firm by carrying on its business, everything connected with the premises and the name of the firm, and everything connected with or carrying with it the benefits of the business." (Lisle, 1903:196)

In this definition the importance of the name of the old firm was highlighted as well as other advantages of the old firm besides the old location and the old customers.

In two further cases in the late nineteenth century, that of *Ginesi v. Cooper & Co* (1880) and *Trego v. Hunt* (1896), the customer relations view of goodwill was again emphasised. Lord Herschell, in *Trego v. Hunt*,

concluded that Sir George Jessel was correct when he decided in *Ginesi v. Cooper & Co.* that attracting customers to a business forming a connection, together with circumstances, whether by habit or otherwise, which tend to make it permanent, is what constitutes goodwill (Dicksee & Tillyard, 1906:31).

In 1901, in the case of *Commissioners of Inland Revenue v. Muller, Lim.* Lord Macnaghten had this to say about goodwill:

> "What is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which bring in custom. It is the one thing which distinguishes an old-established business from a new business at its first start. The goodwill of a business must emanate from a particular centre or source. However widely extended or diffused its influence may be, goodwill is worth nothing unless it has a power of attraction sufficient to bring customers home to the source from which it emanates." (Dicksee & Tillyard, 1906:32).

This definition of goodwill again emphasised the customer relations aspect of goodwill, an aspect that seemed to dominate the perception of goodwill during that time.

Legal recognition of goodwill as an asset was well established in Great Britain in the middle to late 1800's, starting from the early 1743 case mentioned above, when legal recognition of goodwill in America evolved via a series of court cases from 1872 to 1897 (Hughes, 1982:18).

What must however be remembered when looking at the legal definitions of goodwill above is that any specific definition is based on a specific set of circumstances and that the court simply defined goodwill pertaining to the facts and circumstances of each particular case. Like Lall (1968:729) observed, early legal definitions arose from court decisions protecting goodwill of existing businesses and are hence very restricted to goodwill

arising from 'locality of business', 'reputation of the business' or 'business connections' and exclude various other factors which gives rise to goodwill. Definitions of courts of law is authoritative within its own limitations and should not be deemed to be exhaustive as they do not lay down general rules for universal application.

These early legal definitions of goodwill however formed the basis for the early accounting conceptions of goodwill and especially the definition by Lord Eldon became one of the most often quoted definitions in the early accounting efforts to define goodwill.

3.2.2 Customer relations concept of goodwill

As is evidenced from the legal definitions above, the emphasis of the early conception of goodwill was on the relationship between the owner or owners of the business and the customer. This emphasis on the relationship between the owner and his customer came about from a change in the human endeavour from that of wealth maintenance, as in the early manorial system, to the increasing of wealth as represented by the business enterprise, whether as a sole proprietor or as a partnership. As opposed to the manorial system, business enterprise, gaining importance roundabout the fifteenth century, pursued an increase in wealth of its owner or owners rather than just the maintenance of wealth and hence goodwill evolved because one enterprise was more successful in its efforts of increasing wealth than another (Hughes, 1982:11).

The conceptions of goodwill in the sixteenth and seventeenth centuries were therefore products of the type of business dominant at the time. The business was usually small and local and the owner necessarily had plenty of personal contact with his customers. In those circumstances goodwill was accordingly linked with the good feeling of the customers towards the business and the owner because of this friendly and personal

relationship or because the location of the business was in a favourable position (Hughes, 1982:16). The success of an enterprise, in those days, was thus largely determined by the patronage of its customers, either due to their relationship with the owner or because of their relative location to the business and hence the view that goodwill was due to this relationship between the customer and the business.

In the 1884 article of Harris mentioned above, he stated that the name of a firm is also a very important part of goodwill of the business and that when goodwill is sold you part with "...all that good disposition which customers entertain towards the house of business, identified by the particular name or firm, and which may induce them to continue giving their custom to it." (Harris, 1884:9). He then proceeded to prove his point by stating that at that moment there were large firms which did not contain a single member of the individual names in the name of the firm.

In 1888, in a student-essay competition sponsored by the Liverpool Chartered Accountants' Students' Society, the winning paper defined goodwill as:

> "...the benefit and advantage accruing to an existing business from the regard that its customers entertain towards it, and from the likelihood of their continued patronage and support. Hence, it has no relation to a new business, and is only applicable to one already established." (Catlett & Olson, 1968:10).

In the Encyclopedia of Accounting, published in 1903, and edited by George Lisle, various legal definitions of goodwill including those in *Crutwell v. Lye* and *Churton v. Douglas* were given as definitions of goodwill. The following two, what seems to be attempts at accounting definitions of goodwill, were also listed in this encyclopedia namely:

> "Goodwill is the benefit arising from connection and reputation."

This definition was very limited and emphasised only the customer and

the owner's reputation. The following definition was more broader and included the benefit from a favourable location as well:

> "Goodwill is the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds or property employed therein in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or affluence, or punctuality, or from the accidental circumstances and necessities, or even from partialities or prejudices."

Lisle also defined goodwill in his book Accounting in Theory and Practice as follows:

> "Good-will is the monetary value placed upon the connection and reputation of a mercantile or manufacturing concern, and discounts the value of the turnover of a business in consequence of the probabilities of the old customers continuing." (Esquerre, 1915:243).

This relationship between the owner and the customer and the location of the business was so highly thought of at the turn of the century, as being representative of goodwill, that Dicksee & Tillyard (1906:60) listed the following four, what they called 'fundamental', conditions before it could be said that goodwill existed and had a value:

(a) the new owner must have a right to carry on business at the same place as that at which it was formerly carried on;

(b) the new owner must have the right to use the old name and to represent himself as the legitimate successor of the former owners;

(c) there must be an agreement that the former owners will not compete in the same class of business within a reasonable distance of the place of the original business and for a reasonable time; and

(d) the new owner must obtain full control of the books of the business, including all lists of the names and addresses of customers.

Requirements (a), (b) and (d) referred to the 'old location', the 'old name' and the 'old customers' respectively, which were generally accepted as factors constituting goodwill at the time. In fact, these requirements were originally listed by Dicksee in a lecture on goodwill in November 1896 (Dicksee, 1897:41). Requirement (c) however, referred to a restraint of trade requirement, which was only accepted in the seventeenth century in the 1620 court case mentioned earlier. Previous to that case this type of agreement was regarded illegal by the courts and when parties entered into such agreements the parties were subject to fines or imprisonment or both (Hughes, 1982:15).

P.D. Leake (1914:81) referred to the following definition of goodwill to be a specimen of the usual form of definition at the time of his 1914 article:

> "Goodwill - The privilege, granted by the seller of a business to the purchaser, of trading as his recognised successor; the possession of a ready-formed 'connection' of customers, considered as an element in the saleable value of a business, additional to the value of plant, stock-in-trade, book-debts, etc."

Here again, the importance of the customer and his connection to the business was emphasised as being the only element of goodwill. Leake, however, felt this definition to be inadequate and "too narrow" and very restrictive and felt goodwill could not have any real value unless an undertaking was reasonably expected to yield, what he referred to as, "super-profits" i.e. an amount by which future profits (true economic profits according to him) are expected to exceed a normal rate of interest on capital invested. Leake thus became the first author to substantially deviate from the traditional customer relations view of goodwill by basing his conception of goodwill on his theory of super-profits. He would soon be followed by other authors like Yang, Paton and Littleton who also defined goodwill in terms of future excess profits.

3.2.3 Super profits concept of goodwill

As the corporate form of business gained ascendancy in the nineteenth century, the relative importance of the traditional customer relations concept was extended to include every differential advantage a business could obtain. As the individuality of the business was replaced by a corporate structure where the owner performed a lesser role, the earlier concept of the 'good name and reputation' concept of goodwill based on established owner-customer relations was gradually replaced by a new emphasis, that of earnings or profits and especially excess profits.

Probably the first author to mention the valuation of goodwill based on excess profits was Francis More in 1891. Although he still regarded goodwill as "...just another name to designate the patronage of the public.", he suggested that goodwill, which a buyer ought to pay for over and above the value of the tangible assets, should only be paid for if there is a 'return on capital in excess of an ordinary return' (More, 1891:285).

P.D. Leake was the first person, as far as it can be ascertained, to define goodwill directly in terms of excess profits when, in a lecture given to the Leicester Chartered Accountants' Students' Society on the 3rd December 1913, he defined goodwill as follows:

> "Goodwill, in its commercial sense, is the present value of the right to receive expected super-profits, the term "super-profits" meaning the amount by which future revenue, increase or advantage, to be received, is expected to exceed any and all expenditure incidental to its production." (Leake, 1914:82)

Leake (1914:83) felt that the value of goodwill arose solely from "...the inevitable and universal demand for super profits..." and that without the reasonable probability of super-profits, no goodwill of real value can exist.

In the 1930 edition of The Accountants Dictionary, claiming to be "a comprehensive encyclopedia and direction on all matters connected with the work of an accountant", Leake's viewpoints and his definition of goodwill in terms of the super profits approach were quoted almost verbatim.

Authors like Yang (1927) and Paton and Littleton (1940) also held basically the same view as Leake. Yang believed that the payment for goodwill is an advance for the probability of future excess earnings (Emery, 1951:563) while Paton and Littleton viewed goodwill as the discounted value of estimated excess earning power - "...the amount of the net income anticipated in excess of income sufficient to clothe the tangible resources involved with a normal rate of return." (Gynther, 1969:247).

Various later authors, notably Emery, Walker and Spaceck, endorsed this future excess profits concept of goodwill. Emery (1951:560) stated that goodwill is looked upon as the economic advantage enjoyed by a business throughout the different phases of its operations and is evidenced by earnings of an amount greater than expected in a typical firm in the industry with a similar capital investment. George T. Walker (1953:213) argued that a payment for goodwill is because profits in excess of a normal return on investment are anticipated and that a business is acquired not primarily to secure a group of assets but as a means of securing a stream of income in the future. Leonard Spaceck (1964:36) argued that goodwill is the present value placed on anticipated future earnings in excess of a reasonable return on the producing assets. As was seen in the previous chapter the basic mistake they, and indeed Leake, made was to equate the future excess concept of goodwill to its nature which was not correct. The existence of future excess profits are not disputed but it does not reflect the nature of goodwill. The future excess profits approach is merely a method to attach a value to goodwill.

Hendriksen (1982:408), on the contrary, argued that the assumption that tangible assets can only earn a normal rate of return while other factors are responsible for excess returns is fiction and that any attempt to allocate a portion of the vale of a firm on the basis of the capitalization of superior earnings is artificial. Hendriksen is partly correct in that the dividing line between normal profits and superior profits is very subjective and can be artificial, but it cannot be disputed that certain intangible factors inherent within the enterprise do actually produce earnings in excess of a return that would have been earned were they not present.

3.2.4 Momentum theory of goodwill

Robert H. Nelson of the firm Peat, Marwick, Mitchell & Co. published an article in The Accounting Review of October 1953 entitled The Momentum Theory of Goodwill in which he introduced his 'momentum theory of goodwill', contrasting his theory with the super-profits theory advocated by Leake which he referred to as the 'annuity theory of goodwill'.

The momentum theory of goodwill is the premise that a businessman purchases a promotional push instead of an annuity and that the 'push' depletes like momentum (Nelson, 1953:492). According to Nelson, goodwill is difficult to build up and hence a purchaser of a new enterprise is willing to pay an amount for goodwill thereby paying for a 'starting push' in his new business rather than starting fresh in a similar venture and devoting much effort and money in developing goodwill. This 'push' that the new owner receives for his investment is not an everlasting one, but rather like a running start and he has to devote new energy and money to keep it from slowing down.

Nelson compared his momentum theory with the super-profits theory of Leake by equating Leake's theory with an investor who invested in an annuity, the annuity being the future excess profits lasting for a limited

time. He concluded that an investor is not investing in an annuity but is a buyer of a marketing or promotional 'push' (Nelson, 1953:492).

Nelson used his theory to advocate the amortization of goodwill over the period attributed to the purchased momentum. This acquired momentum gives the company the platform upon which it can maintain and increase the existing profitability of the business and writing off goodwill represents the depletion of this momentum (Lee, 1971,323).

The super-profits theory of Leake and the momentum theory of Nelson are rather closely related, the former implying that the purchaser had a right to receive excess profits merely by investing in a firm expected to make excess profits, the latter implying that the investor had a right merely to attempt to make excess profits as a result of his investment. His investment provided access to the possibility of excess profits but no excess returns are guaranteed (Hughes, 1982:118).

3.2.5 Residuum concept of goodwill

Back in 1909, Hatfield suggested that goodwill can best be considered as a term used to explain the difference between the value of a business as a whole and the values attributed to the individual net tangible assets. (Stewart, 1980:9). This view was later endorsed by Paton in 1922 in his book Accounting Theory in which he claimed that the intangibles (goodwill) is the residuum which represents the amount by which the total values of the various tangible assets of the business falls short of the total value of the business taken as a whole (Paton, 1922:310).

The basis of the residuum concept of goodwill is that goodwill is a residue encompassing all those unidentifiable intangible factors that cannot be objectively valued. Stated alternatively, the residuum concept represents the notion that the value of the 'whole' is more than the value of

the 'identifiable parts'.

The residuum concept is similar to the that of Canning's 'master valuation account' approach advocated in his 1929 work, The Economics of Accountancy, in which he described goodwill as a master valuation account in which he included all those intangible factors that cannot practically be valued individually (Canning, 1929:41) but also the aggregate of the under- and over valuations of assets (Canning, 1929:42). Canning thus felt that goodwill was not an asset in the usual sense. His reasoning is based on the premise that all assets obtain their value because of their expected contribution to the stream of future earnings and cash flows and hence the entire value of the firm is based on the assets generating these future cash flows. As it is not possible to allocate the total value of the firm to all the assets, goodwill represents the unallocated value of these assets and hence his view of goodwill as a master valuation account (Hendriksen, 1982:409).

In 1943, May also used similar reasoning to that of Canning in defining goodwill. His contention was that, assuming it is possible to obtain the net present value of the whole entity, goodwill is made up of:

(a) the value of the subjective intangible assets such as 'good name and reputation', 'excellent staff' etc., that cannot be listed and valued separately; and

(b) the errors (both plus and minus) in approximating the individual net present values of those tangible assets for which a direct net present valuation could not be calculated (Gynther, 1969:249).

The view of the residuum concept of goodwill is also taken in the United Kingdom statement on goodwill, **SSAP22,** where goodwill is defined as the difference between the value of a business as a whole and the aggregate of the fair values of its separable net asset (SSAP22:par.26). The same applies to the international statement on business combinations,

IAS22, where goodwill is defined as the excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired (IAS22:par.40).

3.2.6 Intangible resources concept of goodwill

Various authors, although not disagreeing that goodwill exists because excess profits are present and can be measured by the difference between the value of the business as a whole and the value of the net identifiable assets taken over, suggest that goodwill is comprised of various intangible factors within the company. These various intangible factors contributes to the excess earning power of the company and differs from one company to another which means no exhaustive list of these intangible factors can be given. The ones cited most often by proponents of this concept of goodwill are superior management team, harmonious labour relations within the enterprise, special skills and knowledge within the enterprise, monopolistic situation, excellent staff and advantageous business connections. Even some of the early conceptions of goodwill like favourable location, established clientele and good name and reputation are listed amongst these intangible factors. Proponents of this view, particularly Gynther (1969), Weinwurm (1971) and Tearney (1973), argues that these factors should be identified and a value should be put on these intangible factors and the total of these values represents the total value of goodwill.

Tearney (1973:41) and Gynther (1969:248) even go as far as stating that, if all these intangible factors are identified and valued, there would not be an item such as goodwill at all.

This concept of goodwill is endorsed by the Canadian Institute of Chartered Accountants: "Goodwill is considered to be a composite of all the factors which cannot be individually identified and valued and which con-

tribute to or accompany earnings capacity of a company." (CICA 1580: par.54) and by the Australian Accounting Standard Review Board: "Goodwill is the future benefits from unidentifiable assets which, because of their nature, are not normally individually brought to account (AASB 1013:par.10). This concept of goodwill is also endorsed by this study.

3.3 HISTORICAL DEVELOPMENT OF ACCOUNTING TREATMENT OF GOODWILL

The historical development of the actual accounting treatment of goodwill can roughly be divided into three phases. The first phase started with the recognition of goodwill as an asset in the mid nineteenth century and ended with the start of the great depression in the late 1920's. The second phase started after the great depression and ended with the conclusion of World War II in 1944, while the third phase is the current phase since World War II up to 1995.

3.3.1 Phase I : 1884 to 1929

The emphasis on this phase in the development of the accounting treatment of goodwill was the recognition of goodwill as an asset but in the first half of this period to about 1910 there seemed to be an antagonism against including goodwill as an asset in the books of account (Hughes 1982:30). The form of business acquiring the goodwill also had an influence of the accounting treatment of goodwill. In the case of sole proprietors and partnerships the immediate write-off of goodwill seemed to be favoured but the Companies Act In Great Britain at the time prevented companies from writing off goodwill to capital. Thus goodwill could either be left in the accounts as an asset or be written off to revenue (Hughes, 1982:30-31).

The latter half of this period was characterised by great prosperity and a

further development of the company as a corporate institution (Hughes, 1982:41). During this period the policy of charging certain advertising expenses and initial losses of a new business to goodwill also emerged. In pace with the optimistic mood of the time and due to a rise in the general price levels during that time, arbitrary write-ups of assets, including goodwill, also occurred especially in the United States (Hughes, 1982:42).

By this time the value of goodwill based on excess profits was well established (Hughes, 1982:44) and the recording of purchased goodwill at cost was also generally accepted (Hughes, 1982:45). The two methods of accounting for goodwill, after its initial recording, that were most commonly used were the permanent retention of goodwill as an asset and its gradual reduction and as a result each method had its supporters. Esquerre (1915:248) supported the permanent retention of goodwill as an asset and had this to say regarding the writing off of goodwill:

> "Why good-will, having been acquired at a cost which is sometimes considerable, and constituting in some instances the only truly valuable asset of a concern, should be outlawed and sentenced to gradual expulsion from respectable books, is one of the perplexing puzzles which accounting offers to its students."

Leake (1914:87), however, contended that goodwill, based on excess profits, should remain as an asset in the books but "...some provision should be made and charged to revenue account in every year in which super-profits have been earned." His reasoning was that super-profits can never exist permanently because (1) competition is continually at work and (2) the demand for a commodity or service may decrease or terminate owing to changing circumstances (Leake,1914:85).

This period was also characterised by a lack of official guidance by the accounting professional bodies and as such any treatment was acceptable except those that were contrary to corporate law such as writing good-

will off to capital prevented by Britain's Companies Act.

3.3.2 Phase II : 1930 to 1944

The depression of the 1930's had a dampening effect on the optimistic mood predominant during the pre-depression period and led to exceptionally conservative attitudes in business and accounting which led to more conservative treatments of goodwill in this period (Hughes, 1982:75).

During this period a definite shift in the United States towards the cost principle occurred and was evidenced in publications of the American Institute of Public Accountants in **Examination of Financial Statements by Independent Public Auditors** in 1936 and **A Statement of Accounting Principles** in 1938. In 1938 George T. Walker also discussed the practices of capitalising non-purchased goodwill and concluded that:

(a) capitalizing certain advertising expenses "...clearly portrays the fact that advertising expenses are often set up in the goodwill account only as a matter of convenience and...this practice must be condemned if the goodwill account is to be looked upon with favour." (Walker, 1938:257);

(b) capitalising an initial deficit is misleading and "...that a deficit and goodwill are incommensurable and that any attempt to merge a deficit into the goodwill account is irrational and unwarranted." (Walker, 1938:258); and

(c) a direct write-up of goodwill is "...usually unnecessary and unjustifiable." Walker, (1938:259).

Practices like the capitalization of early losses and certain advertising expenses as well as arbitrary write-ups of goodwill, which was prevalent in the pre-depression era in the United States, thus fell into disrepute and the capitalization of purchased goodwill became the only accepted method of recognition of goodwill in the accounts (Hughes, 1982:83).

Preinreich (1937:33) stated that:

> "A great majority of accountants endorse the principle that goodwill ought to be recorded in accounts only if and only to the extent that it was paid for. Among those who are not content with making an unsupported statement to this effect, not all succeed in giving adequate answers."

Authors, listed by Preinreich, who supported this principle included Dicksee, Koehler, Gilman and Hatfield. Hatfield was quoted by Preinreich in stating that "...accounting practice prudently, though perhaps illogically, forbids..." an enterprise to capitalize internally generated clientele which could be sold for a considerable amount and that "...this conservative restriction is doubtless necessary to prevent a harmful exaggeration." (Preinreich, 1937:34). This view of Hatfield was typical of the ultra conservative mood prevailing during this period.

The subsequent treatment of goodwill during this period ranged from retention as a permanent asset, gradual reduction and immediate write-off. In this pessimistic mood, however, a shift transpired from the retention of goodwill as an asset to its elimination from the balance sheet, either by a direct write-off or by a gradual reduction of the goodwill account. The gradual reduction of goodwill could be accomplished by charges to current income, to retained income (earned surplus) or to capital reserves (capital surplus) (Hughes, 1982:85). A direct write-off could be accomplished by a charge to retained income (earned surplus), a revaluation reserve (revaluation surplus) or a capital reserve (capital surplus) (Hughes, 1982:87-88).

During this period the first official pronouncement by a professional accounting body, the American Institute of Accountants, concerning intangibles, and thereby goodwill, was published. **Accounting Research Bulletin No. 24, Accounting for Intangibles,** was published in 1944 but this bulletin did not give clear preference to either permanent retention or

gradual reduction but allowed both methods thus merely reflecting the practices of the time (Hughes, 1982:93). It did however distinguish between two types of intangibles, those with a limited life called type (a) intangibles such as goodwill as to which there is evidence of a limited life, and those with an unlimited life called type (b) intangibles such as goodwill generally. Gradual reduction to current income as opposed to earned surplus was however preferred by the American Institute of Accountants illustrating the concern for proper presentation of income as opposed to assets at that time (Hughes, 1982:102-103).

3.3.3 Phase III : 1945 to 1995

This period after World War II was again characterised by an increase in prosperity and no major depressions like the one in the late 1920,s occurred (Hughes, 1982:111). This period also experienced a large number of business combinations and in the United States, the American Institute of Accountants published its first statement on business combinations, **Accounting Research Bulletin No. 40, Business Combinations,** in 1950.

During this period the controversial poolings-of-interests method of business combinations was introduced in the United States in 1950 which complicated the goodwill issue. This method, whereby two or more companies could merge into one new company by the issue of shares in the emerging company to the shareholders of the acquired companies, effectively allowed a direct write-off of goodwill to shareholders' equity as no goodwill is recorded because the assets, liabilities and equity of the acquired companies are taken over at book values by the new company.

The poolings-of-interest method was severely criticised by various authors including Briloff (1967:496) who concluded his article entitled Dirty Pooling by expressing a hope that the Accounting Principles Board In the United States would "...come around to discrediting and disowning the

pooling device in the interest of fair and relevant reporting of corporate economic data." This followed the recommendation by Wyatt in 1963 in **Accounting Research Study No. 5, A Critical Study of Accounting for Business Combinations,** that the poolings method of business combinations should be disallowed. The controversy was eventually partially settled with the publication of **APB Opinion No. 16, Business Combinations,** in 1970 in which preference was given to the purchase method of business combinations and only allowing the poolings method with stringent provisions.

Various other official pronouncements on either business combinations, intangibles or goodwill by all the major professional accounting bodies were also published during this period and these statements and their development, indicating the development of the accounting treatment of purchased goodwill during this period will be dealt with comprehensively in Chapter 4.

The method that did, however, emerge as the most preferred method by the professional accounting bodies during this period is the capitalization of goodwill as an asset and its gradual amortisation over its estimated useful life subject to certain maximum periods depending on the country involved.

3.4 SUMMARY

The accounting conception of goodwill has changed over the years since the first accounting article in 1884 by Harris. It was first based in the late nineteenth century on various earlier court cases and goodwill was initially defined in terms of the relation between the business and the customer. At the turn of the century with the advent of the business enterprise and the emphasis turning to earnings, goodwill was defined in terms of profits in excess of a normal return or so-called super-profits.

With the advent of the business combination, goodwill was defined in terms of the difference between the acquisition cost and the fair market value of the acquired company's net assets, the so-called residuum approach.

Another, more conceptually sound, method of defining goodwill later emerged whereby goodwill is defined in terms of the various intangible factors contributing to the excess earnings causing goodwill to have a value.

The emphasis of the accounting treatment of goodwill started off with recognising goodwill as an asset but writing it off to capital, especially in the case sole proprietors and partnerships. In the optimistic mood of the early twentieth century various ways of getting goodwill on the balance sheet developed. Purchased goodwill and even certain advertising expenses and initial losses were capitalised as well as arbitrary write-ups of goodwill occurred.

With the depression in the late 1920's and extending well into the early thirties, the optimistic mood changed and the cost principle established itself thereby limiting the recognition of goodwill to that acquired in a purchase transaction. The tendency changed from getting goodwill on the balance sheet to getting it off the balance sheet, first by lump-sum write-offs either against retained income or against capital reserves. When lump sum write-offs were prevented in the United States by APB17 the amortisation of goodwill against income became the only method used in the United States while lump sum write offs against reserves were still permitted in the United Kingdom, even up to now. A more detailed summary of the current accounting treatment of goodwill in the major countries are given at the end of Chapter 4.

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CHAPTER 4

CURRENT STATUS OF INTERNATIONAL ACCOUNTING STANDARDS ON GOODWILL AND ITS DEVELOPMENT

4.1 INTRODUCTION

The treatment of goodwill has been a significant problem facing the accounting profession throughout the world for the last century. The first professional accounting body to issue a statement which mentioned intangibles was the American Institute of Accountants in 1936. In the United Kingdom the first official viewpoint of the Institute of Chartered Accountants in England and Wales dealing with goodwill on consolidation was published in 1971 by way of an exposure draft on acquisitions and mergers. This was only followed by a discussion paper and an exposure draft dealing specifically with goodwill in 1980 which only culminated in an official statement in 1984. It was only in 1983 that the International Accounting Standards Board issued its first official viewpoint on accounting for goodwill by way of an IASC standard on business combinations.

In this chapter a selection of the major countries, where accounting for goodwill has been regulated by statements of generally accepted accounting practice, is analyzed. The countries whose statements on accounting for goodwill or related statements have been selected are the United States of America, Canada, the United Kingdom, Australia, New Zealand and South Africa. All of these countries, except South Africa, have some or other form of statement on either goodwill itself or at least on business combinations or intangibles.

A brief description of the accounting practices concerning goodwill in the European Community are also given. Although these countries, except

the United Kingdom, do not have specific accounting standards dealing with goodwill, they are all legally regulated by the European Community's Fourth Directive on Company Accounts. The International Accounting Standards Committee's statement on Business Combinations concerning goodwill on acquisition will also be analyzed.

4.2 THE UNITED STATES OF AMERICA

In the United States of America the standard setting process effectively started in 1936 with the publication of **Examination of Financial Statements by Independent Public Auditors** by the American Institute of Accountants. This statement was followed in 1938 by the Hatfield, Sanders and Moore publication of **A Statement of Accounting Principles.** In 1944, **Accounting Research Bulletin No. 24, (ARB24),** dealing with intangible assets was published followed by **Accounting Research Bulletin No. 40, (ARB40),** in 1950 dealing with business combinations. In 1953, **Accounting Research Bulletin No. 43, (ARB43),** was published which restated and revised all previous Accounting Research Bulletins, including ARB24 and ARB40. This was followed by another publication on business combinations, **Accounting Research Bulletin No. 48, (ARB48),** in 1957 which replaced ARB43. In 1963, **Accounting Research Study No. 5, A critical study of accounting for business combinations, (ARS5),** by Arthur Wyatt was published. The first publication dealing specifically with goodwill was the Catlett and Olson publication, **Accounting Research Study No. 10, Accounting for Goodwill, (ARS10),** in 1968. In 1970 both **Accounting Principles Board Opinions Nos. 16 and 17, (APB16 and APB17),** dealing with business combinations and intangible assets respectively, were issued which replaced ARB43 and ARB48. APB17 is still the statement that effectively regulates accounting for goodwill in the United States.

4.2.1 Examination of Financial Statements by Independent Public Auditors

This was the first official publication of the American Institute of Accountants which mentioned the basis of valuation of intangibles. This statement stated that plant assets, permanent investments and intangibles are usually stated at cost or on some other historical basis without regard to present realizable or replacement value. Although this statement did not mention goodwill by name, the term "intangibles" included goodwill. Up to the publication of this statement, goodwill could also be recorded in the books by capitalising advertising costs, initial losses of a new company and an arbitrary write-up of goodwill. This statement did not rule out these methods but emphasis was put on the cost principle (Hughes, 1982:79).

4.2.2 A Statement of Accounting Principles

In 1938 Hatfield, Sanders and Moore were the authors of an American Institute of Accountants' publication, **A Statement of Accounting Principles.** Although not the official view of the Institute but those of the authors, they also supported the cost principle being applied to intangibles. They concluded that a value should be placed on goodwill only when goodwill has been purchased and that goodwill which is built up by a business should not be entered in the books (Hughes, 1982:80).

4.2.3 Accounting Research Bulletin No. 24 - Accounting for Intangible Assets

In December 1944, **ARB24, Accounting for Intangible Assets,** was published by the Committee on Accounting Procedure of the American Institute of Accountants. This represented the first time the Institute issued a guideline on the accounting treatment of goodwill and whereby it finally accepted the cost principle for goodwill. ARB24 required that the initial carrying value of all types of intangibles should be cost which was in line

with the generally accepted principle that assets be stated at cost when they are acquired. This effectively prohibited the arbitrary write-up of goodwill as well as the capitalization of early losses (Hughes, 1982:81).

The provisions of ARB24 relating to the treatment of goodwill were summarised by Hughes (1982:92) as follows:

(a) classification of intangibles:
   (i) type (a) intangibles - those having a term of existence limited by law, regulation or agreement, or by their nature - including goodwill as to which there is evidence of limited duration; and
   (ii) type (b) intangibles - those having no limited term of existence and as to which there is, at the time of acquisition, no indication of limited life such as goodwill generally;

(b) initial valuation - cost;

(c) subsequent treatment:
   (i) type (a) intangibles - amortise by systematic charges in the income statement over the period benefitted;
   (ii) type (b) intangibles:
      (1) term of existence remains unlimited:
         (aa) retain indefinitely at cost; or
         (bb) amortise by systematic charges in the income statement; or
         (cc) write-off to earned surplus or capital surplus;
      (2) term of existence becomes limited:
         (aa) amortise by systematic charges in the income statement; or
         (bb) partial write-down to earned surplus followed by amortisation of remainder in the income statement;
      (3) investment becomes partially worthless - this situation not covered; and

(4) investment becomes worthless:
(aa) write-off to income statement; or
(bb) write-off to earned surplus.

This research bulletin neither encouraged nor discouraged the amortisation of goodwill and amortisation was put at par with permanent retention at cost. When the bulletin was issued there was no preference in practice for either permanent retention or amortisation and the research bulletin appears to be a compromise (Hughes, 1982:93).

4.2.4 Accounting Research Bulletin No. 40 - Business Combinations

In September 1950, the Committee on Accounting Procedure issued **ARB40, Business Combinations.** In this bulletin the poolings-of-interests concept was introduced which did not have a direct reference to accounting for goodwill other than the fact that in the poolings concept goodwill built up by either company was not recorded as it was not purchased (Hughes, 1982:127).

4.2.5 Accounting Research Bulletin No. 43 - Restatement and Revision of Accounting Research Bulletins

In June 1953 the Committee on Accounting Procedure published **ARB43, Restatement and Revision of Accounting Research Bulletins,** which incorporated all previous bulletins into one bulletin. ARB24 was replaced by Chapter 5 of ARB43 while ARB40 was replaced by Chapter 7(c) of ARB-43. This bulletin modified the requirements of ARB24 to a large extent. (Hughes, 1982:112). In this bulletin the writing off of goodwill to capital surplus was disallowed and so was the writing off of goodwill to earned surplus immediately after acquisition. The gradual amortisation of goodwill to income was preferred to the permanent retention of goodwill at cost (Hughes, 1982:128).

4.2.6 Accounting Research Bulletin No. 48 - Business Combinations

During January 1957, **ARB48, Business Combinations,** was issued by the Committee on Accounting Procedure. This bulletin replaced Chapter 7(c) of ARB43. Although goodwill was not mentioned in the bulletin, one alternative, pooling-of-interests where shares rather than cash are used for payment, allowed the cost of goodwill to be effectively paid out of equity as no goodwill is recorded as an asset by the purchasing company. Goodwill gets charged off against shareholder's equity in the accounts of the emerging company (Spaceck, 1964:36).

4.2.7 Accounting Research Study No. 5 - A critical study of accounting for business combinations.

In June 1963, the American Institute of Certified Public Accountants published **Accounting Research Study No. 5 - A critical study of accounting for business combinations, (ARS5),** by Dr Arthur Wyatt in which he researched the whole problem of business combinations giving particular attention to the poolings-of-interests method of business combinations resulting from exchange of equity securities (Catlett & Olson, 1968:167).

Wyatt concluded that substantially all business combinations at that time were exchange transactions and that those exchange transactions should be accounted for using the purchase method of business combinations. Under this concept all assets acquired should be recorded at cost being the purchase price of the assets. This study also concluded that the excess of the fair value of the total consideration given in the exchange attributable to goodwill should be amortised over its estimated useful life or if goodwill does not appear to have a useful life it should be carried forward as an asset until evidence appear that its value has diminished (Wyatt, 1963:106).

Robert Holsen, as an addendum to the study, presented an alternative view, **"Another look at business combinations"**. Holsen differed from Wyatt in many respects but regarding goodwill he suggested that the existing practises should be re-examined and companies should be given the option to write off goodwill to earned surplus at the date of acquisition. He also pointed out that if goodwill is amortised to income, the amortisation period is usually arbitrary and does not bear any relation to any proven reduction in its value (Wyatt, 1963:114).

4.2.8 Accounting Research Study No. 10 - Accounting for Goodwill

The next specific publication on goodwill in the United States of America came in 1968 with the publication of **Accounting Research Study No. 10, Accounting for Goodwill, (ARS10)**, by George Catlett and Norman Olson, both partners in Arthur Anderson & Co.

This publication, although published by the American Institute of Certified Public Accountants, did not represent official policy by the Institute as it was clearly stated in the preface that this publication "... does not in any way constitute official endorsement or approval of the conclusions reached or the opinions expressed."

This research study favoured the immediate write-off of goodwill on the basis that goodwill is not an asset. The contention of the authors was that goodwill is not a resource or property right that is consumed in the production of income. It is rather a result of earnings or of the expectations of earnings as valued by investors. Goodwill only exists as part of a business and has no existence separate from the business. The value of goodwill represents the total opinion of the purchaser and is subject to sudden and wide fluctuations which has no reliable or continuing relation to the cost incurred in its creation, its acquisition or its maintenance (Catlett & Olson, 1968:107).

The principal recommendations of this research study can be summarised as follows:

(a) the separate resources and property rights acquired in a business combination should be recorded at fair values at the date of the purchase. The difference between the value of the consideration given and the fair value of the net separable resources and property rights acquired should be assigned to purchased goodwill; and

(b) the amount assigned to purchased goodwill represents a disbursement of existing resources or of proceeds of stock issue to effect the business combination in anticipation of future earnings. This expenditure should be accounted for as a reduction of shareholder's equity. The accounting can be achieved by one of two methods:

    (i) an immediate direct write-off to capital surplus or retained earnings (the preferred method); or

    (ii) showing a reduction from shareholder's equity in the balance sheet for several periods and a later write-off to capital surplus or retained earnings.

This study was severely criticised by especially William Paton and Reed Storey. Paton, in particular, attacked the study's conclusion that goodwill was not an asset. His contention was that assets are not inherently tangible or physical but rather an economic quantum which may be attached to or represented by some physical object, or it may not. (Hughes, 1982: 143). Storey, in his official comment as Director of Accounting Research of the American Institute of Certified Public Accountants, stated that the authors "...do not give a balanced evaluation of the pros and cons of alternative courses but tend to stress the strengths of the alternatives which they prefer to the almost complete exclusion of the weaknesses and tend either to ignore other alternatives or to stress the weaknesses (Catlett & Olson, 1968:163). This view of goodwill was never accepted by the American Institute of Certified Public Accountants.

4.2.9 Accounting Principles Board Opinion No. 16 - Business Combinations

In August 1970 the Accounting Principles Board of the American Institute of Certified Public Accountants issued **Accounting Principles Board Opinion No. 16, Business Combinations, (APB16),** which replaced ARB48. This Opinion dealt with business combinations in general and described the distinguishing criteria between a direct purchase and the poolings-of-interests. This Opinion concluded that both the purchase method and the pooling-of-interests method for business combinations were acceptable although not as alternatives for the same business combination. This Opinion also significantly restricted the poolings-of-interests method which made the recognition of goodwill more probable (Hughes, 1982:152). Paragraph 90 of this Opinion required goodwill, which is recorded in a business combination, to be amortised in accordance with the requirements of APB17 on intangible assets.

4.2.10 Accounting Principles Board Opinion No. 17 - Intangible Assets

At the same time of issuing APB16, the Accounting Principles Board also issued another publication, **Accounting Principles Board Opinion No. 17, Intangible Assets, (APB17),** dealing specifically with intangible assets, including goodwill. This Opinion superseded ARB43.

The main requirements of this opinion are:

(a) the cost of intangible assets (including goodwill) acquired should be recorded as assets;

(b) cost of developing, maintaining or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole, such as goodwill, should be deducted from income when incurred;

(c) the recorded cost of intangible assets should be amortised by sys-

tematic charges to income over the periods estimated to be benefitted;

(d) the cost of each type of intangible asset should be amortised based on the estimated life of that specific asset and should not be written off in the period of acquisition;

(e) the period of amortisation should not exceed forty years;

(f) the straight-line method of amortisation should be applied unless a company can prove that another systematic method is more appropriate. The financial statements should disclose the method and period of amortisation; and

(g) a company should evaluate the periods of amortisation continually to determine whether subsequent events and circumstances warrant revised estimates of useful lives.

The co-author of the 1968 publication, **Accounting for Goodwill**, George Catlett, although a member of the Accounting Principles Board, dissented from this opinion because he still believed that goodwill was not an asset (APB No. 17, 1970).

APB17 is now in use in the United States for more than twenty five years and has been one of the most controversial accounting pronouncements ever issued (Wang, 1995:39) but the issue of IAS22, the International Statement on business combinations in 1993, will have a major effect if adopted in the United States because of its lower period or amortisation; five years, but with a maximum of twenty years, as opposed to forty years currently allowed by APB17.

4.3 CANADA

In Canada, the accounting treatment of purchased goodwill is regulated by **Section 1580** of the **Canadian Institute of Chartered Accountant's Handbook** dealing with business combinations, issued in 1974. In terms

of this section goodwill is described as the total of all the factors that cannot be individually identified and valued and that contribute to, or accompany the earnings capacity of a company. Goodwill in a business combination is represented by the difference between the cost and the purchasing company's interest in the identifiable net assets.

The Canadian Institute believes that goodwill does not have a limitless life as goodwill at the acquisition date gradually disappears and may, or may not, be replaced by new goodwill. It is further felt that goodwill is a cost which is incurred in anticipation of future earnings and should be amortised by systematic charges to income over those future earnings in order to produce proper matching of costs against income. (CICA,1974: Section 1580, par.57).

Goodwill should therefore be capitalised and amortised on the straight-line method over the period estimated to be benefitted from goodwill. This period may under no circumstances exceed forty years and the period of amortisation must be disclosed in the annual financial statements. If there is a permanent diminishment in the value of goodwill, it should be written down against income either as a normal expense or as an extraordinary item, depending on the circumstances which gave rise to the impairment in the value of goodwill. Goodwill, to the extent that it has not been written down, should be disclosed in the Balance Sheet as an intangible asset and may not be written off to reserves or be shown as a deduction off shareholders' equity (CICA, 1974:Section 1580).

4.4 UNITED KINGDOM

The United Kingdom is the most active in the field of Accounting for goodwill starting with **Exposure Draft 30, Acquisitions and Mergers, (ED3),** in 1971. In 1978 the European Community's **Fourth Directive on Company Accounts** was issued giving guidelines on the accounting treat-

ment of goodwill. Following this publication a discussion paper, dealing specifically with goodwill, was issued in 1980. This was followed by **Exposure Draft 30, Accounting for Goodwill, (ED30)**,in the same year, which culminated in Statement of Standard Accounting Practice No. 22, **Accounting for Goodwill, SSAP22,** in 1984. In 1988 another exposure draft on goodwill, **Exposure Draft 44, (ED44),** was issued and in 1989 a revised **SSAP22** was issued. In 1990 another exposure draft on goodwill, this time **Exposure Draft 47, (ED47),** was issued. In 1993 another discussion paper was issued and in 1995 a working paper on accounting for goodwill and intangible assets for a public hearing was issued. The revised SSAP22 is currently the effective statement regulating accounting for goodwill in the United Kingdom.

4.4.1 Exposure Draft No. 3 - Accounting for Acquisitions and Mergers

The standard setting process for accounting for goodwill in the United Kingdom started in January 1971 with the publication of **Exposure Draft No. 3, Accounting for Acquisitions and Mergers, (ED3),** by the then Accounting Standards Steering Committee. Although this exposure draft did not specifically deal with accounting for goodwill, it dealt with the determining of goodwill arising on an acquisition. It stressed the need for attributing fair values to the net tangible and identifiable intangible assets acquired and to attribute the balance of the purchase price over and above these net identifiable assets to goodwill. This exposure draft then suggested that goodwill be written off against shareholders' equity at acquisition.

In a survey done by Lee (1973:185) of accounting practices regarding goodwill in the United Kingdom during the period 1962 - 1971, he discovered that a wide variety of alternative treatments of accounting for goodwill were in use. A large number treated goodwill as an asset and an increasing large number wrote goodwill off to reserves at acquisition or

periodically. A lesser number showed it as a deduction off reserves.

4.4.2 Accountants International Study Group Report - Accounting for Goodwill

In April 1975, the Accountants International Study Group published a report, **Accounting for Goodwill**, which examined current practices of accounting for goodwill in the United Kingdom, the United States of America and Canada. This study group was organized in 1966 by the three Institutes of Chartered Accountants in Great Britain (the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants in Scotland and the Institute of Chartered Accountants in Ireland), the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants.

The conclusions reached in this study are set out below:

(a) goodwill should be defined as being the excess of the purchase price of an acquired business over the fair value of that business's net tangible and identifiable intangible assets;

(b) goodwill should be accounted for as an intangible asset which has a limited life and should be amortised to income on a systematic basis over its estimated useful life;

(c) business enterprises should be encouraged to amortise all goodwill even though it may have arisen in periods prior to the issuance of any pronouncements that require amortisation;

(d) these conclusions on accounting for goodwill apply equally to all purchased goodwill which might arise from the:

  (i) acquisition of the net assets of a business;

  (ii) preparation of consolidated financial statements when the purchase method of accounting is followed for investments in companies consolidated; or

  (iii) accounting for investments on the equity method; and

(e) expenditures made which may result in the development of inter-

nally developed goodwill should be charged to operations when incurred and should not be capitalised and recognised in the balance sheet.

This view did not coincide with current practices in the United Kingdom at the time. In an analysis of the practices adopted by the hundred and fifty largest companies in Britain in 1969/1970, Hinton (1973:29) discovered that the two methods most commonly adopted by these companies were:

(a) capitalising goodwill and either retain it as an asset permanently or arbitrarily writing it off to reserves; and
(b) writing off goodwill to reserves at acquisition.

4.4.3 Accounting Standards Steering Committee - Sub Committees

In 1974 the Accounting Standards Steering Committee commenced working on accounting for goodwill as there were at that stage various ways in use for accounting for goodwill in the United Kingdom. In a survey of published accounts of 1973/1974 the three methods mainly used by companies were:

(a) written off immediately on acquisition;
(b) capitalised and amortised; and
(c) written down, but not identified as amortisation (Holgate, 1985:1).

Two sub-committees were set up to give recommendations on the accounting treatment of goodwill. The one sub-committee recommended that goodwill be treated as an asset and that it should be written off through the profit and loss account over its expected useful life, subject to a maximum of forty years. The other sub-committee recommended that goodwill should not be recognised as an asset but should be written off reserves at the date of acquisition. The Accounting Standards Committee did not accept either of these proposals (Holgate, 1985:2).

4.4.4 European Community's Fourth Directive on Company Accounts

In 1978 the emergence of the European Community's publication of the **Fourth Directive on Company Accounts** required goodwill, if shown as an asset, to be written off over a period of not more than five years. Member States were given the option to write off goodwill over the useful economic life if it extended beyond five years provided that it is disclosed in a note to the financial statements together with reasons why a longer period than five years was used. This directive also allowed an alternative treatment of goodwill, that is, the writing off of goodwill to reserves at acquisition date. This directive however, only dealt with purchased goodwill and not goodwill on consolidation (Holgate, 1985:2).

4.4.5 Accounting for Goodwill - A Discussion Paper

In 1978 the Accounting Standards Board set up a panel under the chairmanship of Michael Renshell to investigate the possible courses that the United Kingdom can take regarding the accounting treatment of goodwill. This was a direct consequence of the publication of the European Community's Fourth Directive (Holgate, 1985:2). In June 1980 the Accounting Standards Committee published **Accounting for Goodwill - A Discussion Paper**. This discussion paper suggested the following treatment for goodwill:

(a) goodwill should not be carried as a permanent item;

(b) goodwill should be amortised over its useful economic life;

(c) the useful economic life should not be longer than the number of years for which the value of the stream of distributable earnings arising from the acquisition is material in relation to the price paid. A mathematical formula was presented which gave a figure of two and a half times the price/earnings ratio applicable to the acquired company as an approximation of that number of years; and

(d) the amortisation period was not to exceed forty years;

These recommendations were very similar to the requirements of APB17, **Intangible Assets**, in the United States of America (Holgate, 1985:2).

Feedback to the Accounting Standards Committee on this discussion paper suggested two main schools of thought. The one school of thought felt that goodwill was unable to be realised separately and thus was not like any other asset. They felt that, as expenditure on goodwill was of no use to users of financial statements, it should be written off directly against reserves on acquisition. The other main school of thought supported the conclusions of the discussion paper and maintained that goodwill was an asset and should, like any other asset with a limited useful life, be amortised over its estimated useful life through the profit and loss account (Holgate, 1985:2).

4.4.6 Exposure Draft No. 30 - Accounting for Goodwill

In October 1980, **Exposure Draft No. 30, Accounting for Goodwill, (ED30)**, was published. This exposure draft's main proposals were:

(a) goodwill should be measured as the difference between the value of a business as a whole (the fair value of the consideration given, in the case of purchased goodwill) and the fair value of its separable net assets;

(b) purchased goodwill should be eliminated from the balance sheet by either an immediate write-off to reserves or amortisation. The policy adopted should be followed for goodwill arising on all acquisitions;

(c) amortisation should be over the useful economic life of the goodwill, subject to a maximum period of twenty years; and

(d) negative goodwill should be credited to reserves.

Comments on this exposure draft indicated a preference for immediate write-off but that the option of amortisation should also be given (Holgate, 1985:3).

4.4.7 Statement of Standard Accounting Practice No. 22 - Accounting for Goodwill

In December 1984, **Statement of Standard Accounting Practice No. 22, Accounting for Goodwill, (SSAP22),** was published as a final standard on the accounting treatment of goodwill. This statement's main features were as follows:

(a) goodwill is defined as the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets;

(b) purchased goodwill is defined as goodwill which is established as a result of the purchase of a business accounted for as an acquisition. Goodwill arising on consolidation is one form of purchased goodwill;

(c) no amount should appear in the balance sheet for non-purchased goodwill;

(d) purchased goodwill should not be carried in the balance sheet as a permanent item;

(e) purchased goodwill should be eliminated from the balance sheet immediately on acquisition against reserves, the so called "immediate write-off" (the preferred method) or purchased goodwill could be capitalised and amortised on a systematic basis against profits (the non-preferred method). No maximum period of amortisation was set; and

(f) negative goodwill, where the net assets acquired exceeds the purchase price, should immediately be credited to reserves.

One of the changes between SSAP22 and ED30 concerned the amortisation period. The statement dropped the proposed twenty year maximum amortisation period on the rationale that:

(a) any maximum period is inevitably arbitrary;

(b) there may be cases where twenty years may genuinely be too

short; and

(c) given that a preference is expressed for immediate write-off, the amortisation method is likely to be used by only a minority of companies and the question of a maximum period becomes of less importance from a practical viewpoint (Power, 1990:13).

This statement of standard accounting practice, however, met with much criticism from accountants, lawyers and practitioners in Britain because of various factors. Holgate (Power, 1990:14) listed the following four main criticisms of SSAP22:

(a) the choice afforded between immediate write-off to reserves, which has no impact on reported earnings per share, and amortisation, which does have an impact on earnings per share;

(b) allowing the same company to use both methods at the same time i.e. writing off goodwill on one acquisition and to amortise goodwill, on another;

(c) the immediate write-off had a major effect on shareholder's funds which did not give a fair reflection of the economics of the transaction; and

(d) amortisation of goodwill was in conflict with the fact that goodwill often increases in value. It was also argued that expenses such as advertising and staff training have the effect of sustaining the value of goodwill and amortisation is then in effect a duplication of an expense.

Boyle (1985:71) concluded that SSAP22 was unlikely to make a significant contribution towards narrowing the areas of difference in financial reporting. He conceded, however, that this statement did eliminate the permanent retention of goodwill on the Balance Sheet. Woolf (1985:121) concluded that compliance with SSAP22 would not in any way relieve users of financial statements of the task of interpreting goodwill policies of companies. Instone, a barrister, stated in an article in Accountancy in

1986, that a fundamental error in the approach of SSAP22 would only mean more work for lawyers and more trouble and expense for clients. He argued that SSAP22's treatment of goodwill on consolidation reflected a fundamental misunderstanding of the nature and function of a consolidated balance sheet (Instone, 1986:15). A number of other articles with headlines such as "Much goodwill - little standardisation", "Companies find holes in goodwill" and "SSAP22 is not the last word on goodwill" and many more appeared in British Accountancy Journals in the first couple of years after SSAP22 became effective.

The criticism of SSAP22 was also linked to the criticism of **Statement of Standard Accounting Practice No. 23, Accounting for Acquisitions and Mergers, (SSAP23),** issued in April 1985. This statement introduced the term "merger accounting" provided certain criteria are met, which is basically the same as the poolings-of-interests method in the USA. If those criteria are not met, the business combination becomes a purchase transaction and goodwill becomes into play. SSAP23 was criticised on the following points:

(a) merger accounting should not be optional but mandatory if the criteria are met;

(b) the merger criteria are too widely drawn; and

(c) merger accounting is inherently unsound (Power, 1990:15).

The requirements of both these standards had the effect that, within a wide range of circumstances, it is actually optional whether goodwill results from a business combination and if it arises it is optional whether it is disclosed on the balance sheet. Indeed an intolerable situation. This overall dissatisfaction with SSAP22 and SSAP23 led to the Accounting Standards Committee deciding in June 1987, a mere three years after the publishing of SSAP22 and SSAP23, to revise these statements.

4.4.8 Exposure Draft No. 44 - Accounting for Goodwill - Additional Disclosures

In September 1988 the Accounting Standards Board (ASC) issued **Exposure Draft No. 44, Accounting for Goodwill - Additional Disclosures, (ED44)**. This exposure draft, as an interim measure while the ASC had a rethink of SSAP22 and SSAP23, set additional disclosure requirements for goodwill. The proposals of ED44 are set out below (Carey, 1988:20):

(a) the full amount of purchased goodwill should be shown in all cases;

(b) the following disclosures should be made for each material acquisition:

   (i) a table showing the book values and fair values of each major category of assets and liabilities acquired;

   (ii) an analysis of the 'fair value' adjustments made, indicating the amount attributable to conforming accounting policies, to revaluations, to provisions (separating out provisions for anticipated future losses) and to any other major item; and

   (iii) a brief explanation of the reasons for the fair value adjustments;

(c) subsequent movements on acquisition-related provisions should be disclosed;

(d) the following disclosures should be made for each significant disposal of a previously acquired business/business segment:

   (i) profit or loss arising;

   (ii) where it occurs within three years of acquisition, the amount of attributable purchased goodwill written off to reserves; and

   (iii) details where the proceeds of disposal are accounted for as a reduction in acquisition cost; and

(e) where goodwill is amortised, the earnings per share before and after the amortisation should be disclosed.

4.4.9 Statement of Standard Accounting Practice No. 22 - Accounting for Goodwill (Revised)

A revised SSAP22 was subsequently issued in July 1989 incorporating most of the proposals set out in ED44. That meant that both options of treating goodwill, the immediate write-off method and amortisation was retained but strengthened with additional disclosure requirement of ED44. The major omission from the revised statement SSAP22, which was proposed by ED44, was the disclosure of the earnings per share before and after the amortisation of goodwill.

4.4.10 Exposure Draft No. 47 - Accounting for Goodwill

Further dissatisfaction with SSAP22 still reigned in Britain. So the Accounting Standards Committee issued yet another exposure draft on goodwill. This time **Exposure Draft No. 47, Accounting for Goodwill, (ED47)**, was issued in February 1990 following doubts that the current practice of allowing a choice between immediate write-off or amortisation was in conflict with the International Accounting Standards Committee's harmonisation proposals set out in **E32, Comparability of Financial Statements**, issued on 1 January 1989 (ED47, 1990:par 1.8). ED47's proposals eliminate the immediate write-off option of SSAP22 and suggested that goodwill be amortised on a systematic basis over its estimated useful life. This exposure draft again proposed a maximum time limit to the write-off. It suggested a period of twenty years with a maximum period of forty years where special circumstances warrant it. If a period of more than twenty years is chosen as the expected useful life of goodwill, the explanation why a period of more than twenty years is justified should be disclosed in the financial statements. This explanation why a longer period is used should explain the circumstances that gave rise to the goodwill and give sufficient explanation to enable the reader of the financial statements to understand the main factors that are

considered to have given rise to the goodwill. This exposure draft also proposed that the directors annually review the goodwill carried in the balance sheet to ensure that both the carrying amount and the useful life is still appropriate (ASC,1990).

The proposals of ED47 again met with major opposition in the United Kingdom which was evident from various articles appearing in British Accounting Journals opposing ED47's proposals. Although there was appreciation of the attempt to eliminate the option that SSAP22 gave on the treatment of goodwill and acceptance that the immediate write-off option had major distortions in reported earnings, the major criticism came against the proposed amortisation of goodwill and especially the seemingly arbitrary period of twenty years. Woolf (1990:92) stated that the systematic amortisation of goodwill will be equally unpopular than the depletion of consolidated reserves by massive goodwill write-offs. Thomas (1990:26) stated that, although there is widespread recognition that immediate write-off against reserves was an anomaly and that goodwill should be capitalised as an asset, the suggestion that goodwill be amortised is based on a misguided idea that goodwill is like any other fixed asset which 'wears out' and its life can be measured.

4.4.11 Urgent Issues Task Force Abstract 3 - Treatment of Goodwill on Disposal of a Business

In 1991 the Accounting Standards Board issued an **Urgent Issues Task Force Abstract 3, Treatment of Goodwill on Disposal of a Business, (UITF3).** The problem that the Task Force faced was the question of how the profit or loss on disposal of a subsidiary should be determined in consolidated accounts, where goodwill arising on the acquisition of the subsidiary has previously been eliminated against reserves in accordance with the preferred method recommended by SSAP22. The Task Force decided that:

(a) the amount included in the consolidated profit and loss account in respect of the profit or loss on disposal of a previously acquired business, subsidiary or associated undertaking should be determined by including, if material, the attributable amount of purchased goodwill where it has previously been eliminated against reserves and has not previously been charged to the profit and loss account;

(b) if there has previously been no charge in the profit and loss account in respect of the premium paid on acquisition, the gross attributable amount should be brought into the calculation;

(c) the amount of purchased goodwill attributable to the business disposed of and included in the calculation of the profit and loss on disposal to be separately disclosed as a component of the profit and loss on disposal, either on the face of the profit and loss account or in a note to the financial statements;

(d) the principles set out in respect of disposals also apply to closures of businesses and to negative goodwill; and

(e) comparative figures for previous years should be restated where applicable.

4.4.12 Discussion Paper - Goodwill and Intangible Assets

In December 1993, the Accounting Standards Board issued **Goodwill and Intangible Assets - A Discussion Paper.** This discussion paper looked at four basic methods of accounting for purchased goodwill and examined for each its rationale, the related conceptual issues and the advantages and disadvantages of each method. The Board did not favour one single method but within the Board there was support for two of the methods namely:

(a) a combination of capitalization and amortisation over its estimated useful life and capitalization and annual review of its value; and

(b) a separate write-off reserve.

The Board was also of the opinion that the prohibition of the recognition of internally generated goodwill should remain.

The four methods discussed in the discussion paper are divided into two groups, namely:

(a) asset based methods; and
(b) elimination methods.

Asset based methods comprise the following two methods or a combination of the two:

(a) purchased goodwill is capitalised and amortised over a predetermined finite life subject to a maximum number of years. Its amortised carrying value is assessed annually for recoverability; and
(b) purchased goodwill is capitalised and amortised through the application of systematic annual review procedures to estimate the annual amortisation charges. There may be years when the amortisation charge is zero.

Elimination methods comprise the following two methods or a third variant based on the second method:

(a) purchased goodwill is eliminated against reserves immediately on acquisition; and
(b) purchased goodwill is transferred to a separate goodwill write-off reserve immediately on acquisition; or,
(c) purchased goodwill is transferred to a separate goodwill write-off reserve immediately on acquisition and the balance in this reserve is assessed for recoverability at each year end. Losses reducing the recoverable amount below the balance in the write-off reserve are charged to the profit and loss account (ASB, 1993:6).

Responses to this discussion paper indicated a lack of support for the preferred method and the single method commanding the greatest sup-

port was the immediate transfer to a separate goodwill write-off reserve (thirty four percent of the respondents). Although fifty percent of the respondents preferred the capitalization of purchased goodwill, half of them opted for amortization over a predetermined life and half of them opted for an annual review only (ASB, 1995:5).

The Board questioned whether the small majority that favoured capitalization would have changed their position had the proposals allowed the recognition of intangible assets separately from purchased goodwill.

4.4.13 Goodwill and Intangible Assets - Working paper for discussion at a public hearing

In June 1995 the Accounting Standards Board issued **Goodwill and Intangible Assets - Working paper for discussion at a public hearing.** In this working paper, the Board reconsidered its approach to goodwill and intangible assets by trying to align the treatment of purchased goodwill and intangible assets as far as possible, especially when the two are very similar in nature.

The proposals of this working paper can be summarised as follows:

(a) goodwill and intangible assets that have limited lives should be amortised over the estimated lives;

(b) goodwill and intangible assets that have indefinite long lives should not be amortised;

(c) all capitalised balances of goodwill and intangible assets should be reviewed for a reduction in value at each year end. The extent of this review would be minimal for goodwill and intangible assets that have a life that does not exceed twenty years and the review would be fuller for those whose estimated lives extend beyond twenty years;

(d) there should be a refutable assumption that goodwill has a limited

life that does not exceed twenty years. This assumption may only be refuted if there are valid and disclosed grounds, based on the nature of the underlying investment acquired, for believing that goodwill has a life longer than twenty years;

(e) internally generated goodwill may not be recognized; and

(f) the balance of goodwill not amortised can either be shown as an asset on the Balance Sheet or shown as a clear deduction from reserves.

The current status of accounting for goodwill in the United Kingdom is thus in a state of flux, perhaps more than any other country, mainly because of the two schools of thought still reigning in the United Kingdom. There are those supporting capitalization and amortisation and others supporting immediate write-off. Perhaps the Accounting Standards Board will get some clarity after the public hearing on goodwill but it seems that public opinion will remain divided.

4.5 EUROPEAN COMMUNITY

4.5.1 European Community's Fourth Directive on Company Accounts

The **European Community's Fourth Directive,** approved by the European Community's Council of Ministers on 25 July 1978, deals with the presentation and contents of the annual financial statements of both public and private companies in the European Community as well as the valuation methods used in these statements and the publication of these documents (Ernst & Whinney, 1979:6). Articles 34(1)(a) and 37(2) of this Directive allow two methods for accounting for purchased goodwill. Purchased goodwill can either be written off immediately against reserves or amortised over a maximum period of five years or over a longer period provided that this longer period does not exceed the useful economic life of goodwill and that it is disclosed in a note to the financial statements

together with reasons why a longer period than five years was used (Holgate, 1985:18).

This directive is applicable to the following European countries: Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands and the United Kingdom. In the United Kingdom the requirements of the Fourth Directive were incorporated into British Company law by means of the Companies Act (Holgate, 1985:19).

4.5.2 Belgium

In Belgium, goodwill is defined as the excess of the cost of an acquiring enterprise over the value of the underlying assets. Intangible assets, which includes goodwill, acquired from third parties are recorded at cost. Intangible assets with limited useful lives are amortised, the rate and method being determined by the company's board of directors. Intangible assets with unlimited useful lives are subject to amortisation only if a permanent loss in value has occurred (Orsini, McAllister & Parikh, Vol 1, 1995:Blg-27).

4.5.3 Ireland

In Ireland, goodwill is only recorded if it was acquired for valuable consideration or written off reserves on acquisition. Goodwill, if recorded as an asset, is recorded at cost and amortised over its useful life while the period of amortisation and the reason for choosing that period should be disclosed (Orsini et al. Vol 2, 1995:Ire-35).

4.5.4 France

In France, intangible assets including goodwill, is recorded at cost. Purchased goodwill should be amortised over a period of five years or

over its estimated useful life if it is longer than five years (Orsini et al. Vol 1, 1995:Fra-34).

4.5.5 Germany

In Germany, capitalization of purchased intangibles, including goodwill, is required while internally generated intangibles, including goodwill, may not be capitalised. Intangible assets should be amortised, using the straight-line method, over its estimated useful lives. If the purchase price of an enterprise exceeds the value of the enterprise's net assets, the excess may be capitalised and amortised over a four year period commencing in the year after acquisition (Orsini et al. Vol 1, 1995:Ger-29).

4.5.6 Italy

In Italy, purchased goodwill is capitalized at cost and amortised over a minimum period of five years but not exceeding ten years. Goodwill may also be written off immediately as an expense (Orsini et al. Vol 1, 1995:Ita-27).

4.5.7 The Netherlands

In the Netherlands goodwill is only capitalised if the future benefits are assured and in excess of future amortisation, or written off reserves on acquisition, while internally generated goodwill may not be capitalised. If goodwill is not charged directly to equity but capitalised, it should be amortised over a period not exceeding five years unless a longer period can be justified. The reasons for the longer period of amortisation must be disclosed (Orsini et al. Vol 2, 1995:Ntl-31).

4.6 AUSTRALIA

4.6.1 Statement of Accounting Standards - Accounting for Goodwill - AAS18

In March 1984 the Australian Society of Accountants and the Institute of Chartered Accountants in Australia issued **Statement of Accounting Standards, Accounting for Goodwill, (AAS18).** This statement was prepared by the Accounting Standards Board and the Australian Accounting Research Foundation and represented the professional accounting bodies in Australia's official viewpoint on accounting for goodwill.

This statement applied to goodwill arising on acquisition of a business entity through the acquisition of the assets therein or in the case of an investment in a subsidiary or an associated company through the acquisition of some or all of the shares therein.

In this statement the goodwill is viewed as being the future benefits arising from unidentifiable assets which, due to their nature, are not normally recorded individually in the accounts. Such unidentifiable assets would include items such as market penetration, effective marketing, good labour relations, and a superior management team.

The main accounting treatment and disclosure requirements pertaining to goodwill prescribed by this statement are:

(a) purchased goodwill should be measured as the excess of the purchase consideration plus incidental expenses over the fair value of the identifiable net assets purchased;

(b) purchased goodwill should be recognised as an asset at acquisition and, except in the case of an investment in an associated company, included in the financial statements as a non-current asset;

(c) purchased goodwill should be amortised by systematic charges

against income, over a period of time during which the benefits are expected to arise. The period over which goodwill is to be amortised should not exceed twenty years;

(d) the period over which goodwill is to be amortised should be reviewed at each balance sheet date and, if necessary, adjustments should be made. Similarly, the unamortised balance of goodwill should be reviewed at each balance sheet date and written down to the extent that it is no longer represented by probable future benefits. Any loss should be recognised in the profit and loss account immediately;

(e) in respect to the amount of goodwill taken up in the financial statements the following should be shown:
  - (i) the unamortised balance of goodwill;
  - (ii) the amount of goodwill amortised during the period;
  - (iii) the policy adopted in amortising goodwill; and

(f) goodwill which is internally generated by the company shall not be brought to account by the company.

4.6.2 Accounting Guidance Release No. 5 - Accounting for Intangible Assets Recognised in Accordance with Statement of Accounting Standards AAS18, Accounting for Goodwill

In December 1985, the Australian Accounting Research Foundation (AARF) issued an **Accounting Guidance Release No. 5 - Accounting for Intangible Assets Recognised in Accordance with Statement of Accounting Standards AAS18, Accounting for Goodwill, (AGR5).** The purpose of this release was to remind companies of the requirement of AAS18 that intangible assets comprising goodwill should be amortised over its useful life. This was in response to a number of Australian companies not complying to this amortisation requirement of AAS18 (Carnegie & Kallio, 1988:50).

4.6.3 ASRB 1013/AASB 1013 - Accounting for Goodwill

In April 1988, the Accounting Standards Review Board effectively approved Statement AAS18 without any material change by issuing **ASRB 1013, Accounting for Goodwill** (Williams & Carnegie, 1989:89). This effectively made the standard law in terms of Australian corporate legislation and made applicable to financial years ending on or after 19th June 1988. ASRB 1013 was then replaced by the current standard, **AASB 1013, Accounting for Goodwill** but the contents remained the same.

4.6.4 Australian Securities Commission Practice Note 39 - Accounting for Goodwill

In November 1993, the Australian Securities Commission (ASC) issued **Practice Note 39, Accounting for Goodwill.** The purpose of this practice note was to guide ASC staff in monitoring compliance with AASB 1013 and to assist directors and other preparers of financial statements, along with auditors, so that they may understand the views which the ASC intends to apply regarding the amortisation of goodwill (ASC, 1993:139).

This practice note dealt with four aspects of AASB 1013 namely:

(a) the choice of method in amortising goodwill;

(b) the choice of the period of amortisation;

(c) the annual review of the unamortised balance of goodwill at the year end; and

(d) the disclosure requirements regarding goodwill.

As regards the choice of the amortisation method used, the ASC's view is that it would be difficult to envisage circumstances where the future benefits accruing from goodwill would be more in the later years of the useful life of goodwill and thus methods such as the inverted-sum-of-the-digits method would only be justified in "rare and exceptional cases"

(ASC, 1993:140).

As regards the maximum period of write-off of twenty years allowed by the Standard, the view of the ASC is that this long period may be inappropriate in many cases and should only be used when the benefits expected to be derived from goodwill do actually extend beyond twenty years (ASC 1993:140).

During 1995, the Australian Securities Commission tried to enforce the compliance to AASB 1013 by Australian Companies (Miller, 1995:3). The commission was however criticised for its prescriptive interpretation of the amortisation requirement of AASB 1013. The Australian Accounting Standards Board (AASB) was also pressurised to have a re-look at the mandatory amortisation of goodwill by Australian companies which allegedly put Australian companies at an international disadvantage because companies in Britain and the European Community were allowed to write off goodwill on acquisition to reserves while USA companies could write off goodwill over as many as forty years. This drive clashed with a growing Australian commitment to the international statement as the Australian statement was in line with IAS22 (Miller, 1995:3). In a statement issued by the AASB in August 1994, it was stated that the AASB did not contemplate revising AASB 1013 as it was consistent with IAS22 requirements. The Board then undertook to raise the issue of UK and USA companies not complying with international standards at meetings of national standard setters and the International Accounting Standards Committee (Miller, 1995:12).

4.7 NEW ZEALAND

4.7.1 Research Bulletin 112 - Accounting for Goodwill

In September 1980 **Research Bulletin, Accounting for Goodwill, (R-112),**

by R.E. Stewart, was published by the Accounting Research and Standards Board of the New Zealand Society of Accountants. This was the first attempt by the New Zealand Society to formalise a general approach to the goodwill problem. In this study Stewart (1980:29) concluded that goodwill was a nebulous and abstract concept and that the most appropriate concept it can be identified with is the intangible resources concept. He further concluded that, within the historical cost accounting framework, goodwill is an asset which should be amortised over its useful economic life. He conceded that the amortisation procedure will be an arbitrary process because of the difficulty in assessing the life of goodwill but suggested that an assessment could be made if the intangibles comprising goodwill are identified. He argued that goodwill cannot continue to be recorded at its original cost as the intangibles causing goodwill's existence have their effect over a limited period. He conceded that other factors may well contribute to the establishment or maintenance of goodwill but he was convinced that the original goodwill purchased has a limited life and should therefor be amortised.

4.7.2 Statement of Standard Accounting Practice No. 8 - Accounting for Business Combinations

In July 1987 The Accounting Research and Standards Board of the New Zealand Society of Accountants issued **Statement of Standard Accounting Practice No. 8 - Accounting for Business Combinations, (SSAP-8).** This statement dealt with the appropriate treatment of purchased goodwill arising on consolidation, using either the purchase method or the equity method. This statement, however, did not deal with ordinary purchased goodwill nor negative goodwill (or discount on acquisition as it is called in New Zealand).

4.7.3 Exposure Draft No. 43 - Accounting for Intangibles

In July 1988 the Accounting Research and Standards Board of the New Zealand Society of Accountants issued **Exposure Draft No. 43, Accounting for Intangibles, (ED-43)**, which included proposals on the appropriate treatment of purchased goodwill.

The main proposals of this exposure draft regarding goodwill were:

(a) goodwill is regarded as future benefits and should be recognised as an asset and measured as the amount by which the cost of acquisition exceeds the fair value of net identifiable assets acquired;

(b) goodwill has a finite life and should be amortised by systematic charges to the profit and loss account;

(c) in determining the estimated useful life of goodwill the following factors should be taken into consideration:
    (i) relevant legal, regulatory or contractual provisions;
    (ii) effects of obsolescence, demand, competition and other economic factors;
    (iii) service life expectancies of individuals or groups of employees;
    (iv) expected constraints on economic choices;

(d) the maximum life of goodwill would be unlikely to exceed ten years and in no case should exceed twenty years;

(e) goodwill should be reviewed regularly and when there has been a permanent reduction in the value of goodwill, it should be written off to the profit and loss account immediately; and

(f) discount on acquisition, or negative goodwill, should be eliminated by a proportionate reduction of the fair values of non-monetary assets acquired. If, after all non-monetary assets have been reduced to zero, a balance remains, it should be regarded as a gain and taken to the profit and loss account.

Following the comments received on ED-43, SSAP-8 was revised in 1990 which lead to the withdrawal of R-112 and ED-43.

4.7.4 Statement of Standard Accounting Practice No. 8 - Accounting for Business Combinations (Revised)

The revised **SSAP-8, Accounting for Business Combinations**, still only dealt with goodwill on consolidation and its main guidelines on goodwill are:

(a) goodwill on consolidation represents a premium paid over the fair values ascribed to net identifiable assets;

(b) goodwill should be amortised on a systematic basis over the period during which the benefit represented by goodwill is expected to accrue to the investor. Such period is unlikely to exceed ten years and should in no case exceed twenty years;

(c) goodwill arising on consolidation should be reviewed regularly and where there has been a permanent reduction in its value, it should be written off to the profit and loss account; and

(d) a discount on acquisition (negative goodwill) should be accounted for by reducing proportionately the fair values of the non-monetary assets until the discount is eliminated. Where, after reducing to zero the recorded amount of non-monetary assets acquired, a discount remains, it should be classified as a gain and taken to the profit and loss account.

New Zealand thus has no specific statement on accounting for goodwill except the sections in SSAP-8 dealing with goodwill on consolidation. SSAP-8 is currently under revision and an exposure draft is expected soon. The revised SSAP-8 is likely to retain a position close to IAS22 under the harmonisation directive of the IASC (Mackenzie, 1995:45).

4.8 SOUTH AFRICA

4.8.1 Discussion Paper No. 3 - Accounting for Goodwill

South Africa entered the goodwill debate quite late with the issuance of **Discussion Paper, Accounting for Goodwill, (DP3)**, in 1982. The main proposals in DP3 were much in line with the proposals set forth in the discussion paper issued in June 1980 by the Accounting Standards Committee in the United Kingdom.

The main proposals of DP3 were as follows:

(a) goodwill should be amortised over its estimated useful life which should be taken as not being longer than the number of years for which the value of the stream of distributable earnings arising from the acquisition of a business is material in relation to the price paid to acquire that business. A figure of two and a half times the price/earnings ratio applicable to the acquired company is suggested with a maximum of forty years;

(b) the value of goodwill should be based on the fair value of the net assets acquired;

(c) goodwill not yet written off, should be disclosed under fixed assets in the Balance Sheet;

(d) if at any time the amount of goodwill is seen to be irrecoverable in full it should be written down immediately to the estimated recoverable amount; and

(e) negative goodwill should be recognised where it arises and treated as the opposite of positive goodwill, i.e. by crediting it to the income statement in annual instalments. The cumulative amount written off should never exceed the total depreciation charged on the assets of the subsidiary since acquisition by the group, together with any element of the proceeds on disposal of assets by the subsidiary which corresponds to a surplus at the date of acquisition of

the fair value of those assets over their book value.

This discussion paper has, however, subsequently been withdrawn and to date no further discussion paper or any other proposed guideline has been issued by the Accounting Practises Committee.

4.8.2 Current practice

In a study done by Brenda Gourley (1986:388) of the Natal University during 1986 on the then current practices for the treatment of goodwill in the latest financial statements of fifty companies listed on the Johannesburg Stock Exchange, disclosed that a large percentage (76 %) of the companies either wrote off goodwill on acquisition or set it off against a non-distributable reserve. In 1989, another survey of financial reporting in South Africa revealed that the two most favoured approaches to goodwill were either the immediate write-off method or goodwill being set off against shareholders' equity (Wilmot, 1989:88).

In the absence of a definite guideline from the South African Institute of Chartered Accountants, Everingham & Hopkins (1982:238-2) suggest that no specific method be prescribed, but companies should rather aim for fuller disclosure of the method adopted along the United Kingdom's requirements. This however is not advisable as the United Kingdom's requirements are not in line with the International Accounting Standards Committee's requirements in IAS22 issued in 1993 which effectively disallows the immediate write-off option. Although international standards do not override local regulations, in the absence of a local statement South Africa should be following the requirements of IAS22.

4.9 INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

The International Accounting Standards Committee does not have a spe-

cific statement dealing with goodwill exclusively, but the matter of goodwill on acquisition is dealt with in **International Accounting Standard No. 22, Business Combinations,** which was originally issued in 1983 as **Accounting for Business Combinations** and revised during 1993.

4.9.1 International Accounting Standard No. 22 - Accounting for Business Combinations

The original IAS22 allowed the recognition of goodwill as an asset in the consolidated balance sheet or allowed the immediate write-off or adjustment to shareholders' interests. If purchased goodwill had been capitalised, it represented a payment made in anticipation of future income and it should be amortised to income on a systematic basis over its estimated useful life.

In estimating the useful life of goodwill, the Committee (IAS22, par. 44) gave a guide to the factors that should be considered in estimating that useful life, namely:

(a) the foreseeable life of the business or the industry;
(b) the effects of product obsolescence, change in demand and other economic factors;
(c) the service life expectancies of key individuals or groups of employees;
(d) expected actions by competitors; and
(e) legal, regulatory or contractual provisions affecting the useful life.

4.9.2 International Accounting Standard No. 22 - Business Combinations (Revised)

The revised IAS22 has the following requirements regarding purchased goodwill arising from business combinations:

(a) goodwill is described as any excess of the cost of the acquisition

over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction;

(b) purchased goodwill should be recognised as an asset as from the date of acquisition as it represents a payment made by the purchaser in anticipation of future economic benefits;

(c) goodwill should be amortised by recognising it as an expense over its useful life;

(d) in amortising goodwill, the straight-line method should be used unless another amortisation method is more appropriate in the circumstances;

(e) the amortisation period should not exceed five years unless a longer period, not exceeding twenty years from the date of acquisition, can be justified;

(f) the unamortised balance of goodwill should be reviewed at each balance sheet date and, to the extent that it is no longer probable of being recovered from the expected future economic benefits, it should be recognised immediately as an expense. Any write-down of goodwill should not be reversed in a subsequent period;

(g) when the cost of the acquisition is less than the fair values of the identifiable assets and liabilities at the date of acquisition, the fair values of the non-monetary assets acquired should be reduced proportionately until the excess is eliminated. When it is not possible to eliminate the excess completely, the remaining excess should be described as negative goodwill and treated as deferred income;

(h) negative goodwill should be recognised as income on a systematic basis over a period not exceeding five years unless a longer period, not exceeding twenty years from the date of acquisition, can be justified; and

(i) the financial statements should disclose:

   (i) the accounting treatment for goodwill and negative goodwill including the period of amortisation;

(ii) when the useful life of goodwill or the amortisation period for negative goodwill exceeds five years, justification of the period adopted;

(iii) when goodwill or negative goodwill is not amortised on the straight-line method, the basis used and the reason why that basis is more appropriate than the straight-line basis; and

(iv) a reconciliation, in respect of both goodwill and negative goodwill, at the beginning and end of the period showing:

   (aa) the gross amount and the accumulated amortisation at the beginning of the period;

   (bb) any additional goodwill or negative goodwill recorded during the period;

   (cc) amortisation charged during the period;

   (dd) adjustments resulting from subsequent identification or changes in value of assets and liabilities;

   (ee) any other write-offs during the period; and

   (ff) the gross amount and the accumulated amortisation at the end of the period.

The revised statement gave the same factors that had to be considered in estimating the useful life of goodwill. This revised statement effectively prohibits the immediate write-off of purchased goodwill against shareholders' equity, a method currently still allowed in the United Kingdom.

4.10 SUMMARY

Accounting for goodwill in the United States is currently regulated by **APB17**, issued in 1970, which requires goodwill to be capitalised as an asset and amortised systematically over its estimated useful life which may not exceed forty years. In Canada accounting for goodwill is regulated by **Section 1580** of the **CICA Handbook**, issued in 1974, which, like the USA, requires goodwill to be capitalised and amortised using the

straight line basis over the period goodwill is expected to be benefitted from, not exceeding forty years.

In the United Kingdom, accounting for goodwill is regulated by **SSAP22 (Revised),** issued in 1989, which gives a company the option of an immediate write-off to reserves or capitalization and systematic amortisation over its estimated useful life. This statement is currently under review with the main proposal being the elimination of the immediate write-off option to bring it into line with international requirements. In the European Community, goodwill is regulated by the **Fourth Directive on Company Accounts,** issued in 1978, which allows goodwill to be written off immediately against reserves or capitalised and amortised over a maximum period of five years. A longer period of amortisation may be used if the estimated useful life of goodwill is longer, provided the fact and the reasons for the longer period is disclosed.

In Australia, accounting for goodwill is regulated by **AASB 1013,** issued in 1988, which requires goodwill to be capitalised and amortised systematically over its estimated useful life not exceeding twenty years. In New Zealand, goodwill is regulated by **SSAP-8,** issued in 1987 and revised in 1990, which requires goodwill to be capitalised and amortised systematically over the estimated period goodwill is expected to be benefitted from. This period is normally ten years but may not exceed twenty years.

The international standard, **IAS22** issued in 1983 and revised in 1993, requires goodwill to be capitalised and amortised over a period of five years using the straight line method unless another method of amortisation can be justified. A longer period of amortisation may be used but this period may not exceed twenty years.

In South Africa there is no official guideline on accounting for goodwill

and companies should ideally adopt the method prescribed by the International Accounting Standards Committee in **IAS22, Business Combinations.** The method adopted should also be properly disclosed in terms of **Statement AC101, Disclosure of Accounting Policies**, Paragraph .20.

All the official pronouncements of accounting bodies throughout the world seem to favour the capitalization of goodwill as an asset with its systematic amortisation, or at least have it as an option. The main point of difference seems to be the period of amortisation ranging from five years required by the international statement to forty years allowed by the American Statement. The European Community's Fourth Directive as well as SSAP22 in the United Kingdom currently allows an immediate write-off against reserves although the latest discussion paper in the United Kingdom proposes that this method be abolished to bring it in line with the international IAS22 requirements.

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CHAPTER 5

ANALYSIS OF CURRENT METHODS OF ACCOUNTING FOR GOODWILL

5.1 INTRODUCTION

Over the years various methods of accounting for goodwill had been advocated by different authors of accounting literature. Strong arguments for each method were given by the proponents of each specific method with equally strong arguments against the alternative methods.

Several studies done over the past half century revealed the array of accounting practices employed for goodwill. Results published by Walker (1938) in the United States, Lee (1971) in the United Kingdom, Brooking & Woods (1981) and Gourley (1986) in South Africa, Kirkness (1987), Carnegie & Kallio (1988) and Wines & Ferguson (1993) in Australia, all showed that various methods of accounting for goodwill were adopted by companies, especially where these practices were not, at the time of the survey, governed by some accounting standard, in particular in the case of South Africa where no such standard exists.

In the study done by Wines & Ferguson regarding accounting policies on goodwill followed by Australian companies during 1985 to 1989 they identified as many as ten different methods used. They summarised the methods as follows:

(a) goodwill is capitalised and amortised systematically;
(b) goodwill is capitalised and amortised non-systematically;
(c) goodwill is capitalised and the amortisation is treated as an extraordinary item;
(d) goodwill is capitalised as an asset and not amortised;
(e) goodwill is treated as a cumulative deduction from shareholders'

equity and not amortised (dangling debit);

(f) goodwill is written off in a lump sum as an extraordinary item;

(g) goodwill is written off as a lump sum against retained earnings or reserves;

(h) goodwill is written off as an abnormal item 'above the line' in the profit and loss account;

(i) goodwill is written off systematically while lump sum write-offs as extraordinary items are also made; and

(j) goodwill is written off systematically while abnormal write-offs 'above the line' are also made (Wines & Ferguson, 1993:94).

These ten methods can, however, be reduced to four main distinguishable methods of accounting for goodwill which in turn can be summarised as follows:

(a) goodwill is retained indefinitely as an asset in the balance sheet at its original purchased cost unless a permanent reduction in its value becomes apparent in which case its should be written off accordingly;

(b) goodwill is written off at the date of acquisition in its entirety against retained earnings and more specifically reserves at the acquisition date;

(c) goodwill is shown at its original cost as a separate identifiable amount in the balance sheet, not as an asset but as a deduction off shareholder's equity; and

(d) goodwill is capitalised as an asset at acquired cost and amortised systematically over its estimated useful life or over an arbitrary prescribed period.

Another, occasionally used, method is to write off goodwill against share premium in the case of a share for share exchange.

Each of these five methods will be critically evaluated in terms of the

theoretical framework for goodwill established in Chapter 2 and the arguments for and against each alternative treatment will be contrasted to determine the method that is conceptually the most appropriate.

5.2 MAINTAIN GOODWILL AS AN ASSET UNAMORTISED

This method is based on the premise that goodwill is an asset and from that point of view it is conceptually sound as it has been concluded in Chapter 2, goodwill is most definitely an asset. The reasoning put forward by the supporters of this method hinges on the argument that goodwill, and thereby the factors constituting goodwill, is not consumed or used up and therefore does not lose its value but in fact is being maintained by constant expenditure on the part of the enterprise. Goodwill from this viewpoint thus has an indefinite life and its value does not depreciate, like any other depreciable asset, but in fact fluctuates aimlessly (Hughes, 1982:202). Eiteman (1971,48) suggested that "...purchased goodwill is not a finite-lived asset like a building, equipment or a patent. It is an investment by a buying enterprise in a group of intangible resources of the selling company...As an "investment asset" it should be carried at an unamortised amount in the balance sheet as long as there is no evidence that its value has been impaired or that its term of existence has become limited."

This view of goodwill was one of the earliest viewpoints on the subsequent treatment of goodwill in the accounts of corporations. As far back as 1902 Browne (1902:1342) stated that: "...as Goodwill is an asset distinctly paid for by shareholders and represented in their capital on the opposite side of the Balance Sheet, profits should not be subject to a charge for its reduction or extinction." He went on to say that "...the very possibility of being able to apply current profits to the reduction or extinction of Goodwill, as it stands in the books, is one of the best proofs of its value." Esquerre (1915:248) declared that "...it seems that if a

concern has paid a large sum to acquire the good-will of another, and has not only retained it but even increased it, there is no apparent reason why so-called conservatism should demand the writing off of the asset to the detriment of the very profits which its purchase gave the right to expect."

The argument that goodwill is an asset that does not lose its value can be countered by the argument that its is not the original purchased goodwill that retains or increases its value but the total goodwill of the business (Everingham & Hopkins, 1982, Service 13, 1989:230). Purchased goodwill is constantly being replaced by inherent goodwill so that it appears that the value of the purchased goodwill remains the same or is even increased. Furthermore, the mere fact that the value of goodwill needs to be maintained or replenished by additional expenditure is in fact proof that the original purchased goodwill does have a limited life and does lose its value and therefore accounting for the replacing goodwill should be distinguished from the accounting for the replaced goodwill (Stewart, 1980:17).

More important, proponents of this argument also loses sight of the difference between the value of an asset and the cost of an asset. The value of an asset is determined by a valuation process while the cost is determined by the expenditure of resources. Thus, it is irrelevant whether the value of an asset remains the same, it is the cost that must be amortised and matched with related income, in the case of goodwill with excess earnings. Walker (1953:213) correctly argued that the conclusion that goodwill should not be amortised because its value has not diminished is based on this erroneous confusion between the value of an asset and its cost. He emphasised the fact that, under the historical cost income model, amortisation charges are not made to show the value of an asset but to allocate the cost of the asset to related income over its useful life.

Another argument put forward by those believing goodwill should be maintained as an asset and not amortised is that goodwill is a result rather than a determinant of earnings. The cost of goodwill is a payment for the result of earnings, or the expectation of them, and this cost is not utilised or consumed in the production of those earnings (Eiteman, 1971: 48). Leonard Spaceck, in his comments on **Accounting Research Study No. 10,** stated that "Goodwill is not a value consumed in the production of profits. It doesn't wear out; it can grow instantly or cease to exist instantly-..." (Catlett & Olson, 1968:156). Goodwill in this sense is thus neither required for nor consumed in the generation of income and to amortise goodwill will only eliminate the very earnings that create it, thereby significantly damaging the functionality of the financial statements (Hinton, 1973:33).

Here again, the proponents of this view confuses the cost of the purchased goodwill with the value of total goodwill of the enterprise. It is the cost of the purchased goodwill that diminishes, not the total value of goodwill. Purchased goodwill is nothing more than a payment made by the acquiring company for expected excess future earnings which should be matched with the excess earnings when realised to comply to the matching concept.

A further argument put forward for maintaining goodwill at its purchased cost is that, taking into account that the expenditure incurred in maintaining the value of goodwill is charged to the income statement as and when incurred, the amortisation cost, if goodwill is to be amortised, results in a double charge to earnings. George May, in 1943, observed that he cannot see how the assumptions of those who would amortise goodwill can lead to conclusions resulting in a charge against income of both a write-off in respect of an old asset and the cost of an exactly similar new asset that has taken its place. According to him this reasoning would justify the charging of depreciation and the cost of replacement in respect

of a physical property to earnings.

May was supported by Staub in 1945 who concluded that:

> "...the income of the period is being doubly charged, once with the expenditure for the maintenance of the value of intangibles, and again with the cost of the intangibles, the value of which is being maintained. Such a double charge against operations of a period seems especially objectionable when the net income is being used as an indication of current earning power and consequently a factor in estimating the value of the intangibles which have been used in realising the net income." (Catlett & Olson, 1968:87).

Paul Grady (1950:12) also felt that goodwill should be retained at cost and had the following opinion regarding the amortisation of goodwill, also supporting the 'doubling of expenses' view:

> "Similarly, the charging off of unlimited intangibles such as goodwill...which are being fully maintained would result in an understatement of cost of fixed assets and an overstatement of expenses."

More recently Thomas (1990:26) also referred to this double charge when he stated that, having acquired goodwill, the purchaser will not watch it disappear but will want to maintain its value with further investment in advertising, promotion etc., all expenses charged against profits in the year the costs are incurred. He then concluded that goodwill amortisation "...apart from ignoring the fact that the value of goodwill is being maintained, will represent a double charge to the profit and loss account."

Exposure Draft No. 47, Accounting for Goodwill, (ED47), refuted the double charging argument on two grounds namely:

(a) the expenses to maintain goodwill, or even further develop it, is not distinguishable from the expenses incurred in the continuing operations of a business to realise other direct benefits and it can thus be seen as a free by-product and thus as having no cost. There is

therefore no double charging as the amortisation charge is the only cost for goodwill; and

(b) there is identifiable expenditure on maintaining and replacing goodwill and there has also been expenditure in acquiring goodwill. Thus, there has been dual expenditure and the effect should therefore rightfully be a double charge to the profit and loss account (ED47:par 38)

Unwin (1990:29) supported the second argument in ED47 when he claimed that the superimposition of goodwill amortisation charges on the effect of so-called goodwill-creating expenses does not, in effect, comprise a double counting of expenses as two sorts of goodwill are consumed namely (a) purchased goodwill and (b) internally generated goodwill. He further claims that under ideal circumstances inherent goodwill would also have been capitalised and amortised and that the difference would only be in the timing of the expense.

Myddelton (1994:90) perhaps best summarised the double charge debate when he commented as follows:

> "It is not a 'double charge' to amortise goodwill [x] against profits as well as writing off current expenditure on internal goodwill [y]. The total write-off against profits is then [x+y]. But we must not overlook the amount of expected future annual benefits [z] that a group was prepared to pay for when it acquired goodwill, This is the offset to x, leaving a net write-off of y-[z-x]. Under the matching concept, it is wrong for groups to include z (the 'super-profits') in profits unless they amortise x against them."

A further argument put forward by the supporters of the non-amortisation of goodwill is that, by amortising goodwill a 'secret reserve' is created while the actual value of goodwill has remain intact. Montgomery's concern regarding the amortisation of goodwill was that "...if written off, a secret reserve might be created;..." while Dicksee argued that the amorti-

sation of goodwill "...is to create a reserve fund without stating it as such - or in other words a secret reserve" (Preinreich, 1937:38). It is similar reasoning to that of Stacy (1987:22) who argued that to amortise goodwill would be equivalent to retain cash in the business because amortisation according to him is "...an accounting mechanism for converting physical assets into cash which can be re-invested in the replacement of worn out assets." His argument is that there is no need for such cash as it cannot repurchase the characteristics that justified the original goodwill payment and need not do so if profitability is maintained or improved.

This argument does not hold true because amortisation, although reducing retained earnings and therefore distributable reserves, does not neccesarily provide funds for the replacement of assets. Amortisation is primarily a cost allocation concept and not a capital maintenance concept (Njeke, 1991:192).

As regards the life of goodwill, Eiteman (1971:48) used the argument that the unidentifiable assets comprising goodwill are generally, by nature, those types of intangibles that have no limited term of existence and thus no indication of a limited life at the date of acquisition. He therefore concluded that goodwill has an indeterminate life and therefore there is "...simply no sound basis on which the expense for a single period or longer can be calculated."

This argument can be criticised on two grounds namely:

(a) the factors comprising goodwill do in fact have a limited lifespan as they need to be constantly replenished with further expenditure; and

(b) although it is true that the life of goodwill is based on estimates and judgement, the same argument holds true in the case with the lives of other fixed long term assets, for example plant and equipment. Like Unwin (1990: 29) stated that, to a greater extent, prob-

lems of uncertainty about the useful lives of tangible assets, due to rapid technological advances, do not deter accountants from exercising judgement over them, but they shy away from exercising the same judgement in estimating the life of goodwill.

The main arguments in favour of retaining goodwill as an asset unamortised can thus be summarised as follows:

(a) goodwill is an asset that does not lose its value and as such should be retained at cost until a permanent reduction in its value is apparent;

(b) maintaining the value of goodwill by expenditure on items such as advertising and promotion, market support, training, technical support etc. as well as amortisation charges will result in a double charge to the profit and loss account;

(c) it is not appropriate to amortise goodwill when it has not depreciated in value and to amortise goodwill in this case would be in effect creating a 'secret reserve'; and

(d) the life of goodwill is indeterminate and thus not measurable.

5.3 WRITE OFF GOODWILL TO RESERVES AT ACQUISITION

This method relies mainly on the assumption that goodwill is not an asset in the normal sense of the word because it cannot be realised separately. Purchased goodwill is regarded as a once-off payment associated with an acquisition and since it is unlikely, under certain conditions, that this goodwill will continue to exist after the acquisition, it is prudent to eliminate it from the balance sheet immediately (Everingham & Hopkins, 1982, Service 13:232-233).

As it has been concluded that goodwill is an asset, this reasoning is conceptually unsound and should be dismissed. **SSAP22, Accounting for Goodwill,** in the United Kingdom still allows this method as a preferred

option for treating goodwill together with the capitalization and amortisation option. This prompted Greener (1989:26) to make the following comment:

> "If goodwill arising on consolidation is acknowledged as a wasting asset to be systematically written off in the manner of other wasting assets, then it cannot at the same time, without making a mockery of accounting theory, be categorised as an item properly charged to reserves."

ED47 proposed the elimination of the option of the immediate write-off of goodwill to reserves and used the following as arguments why the immediate write-off of goodwill to reserves is a problem:

(a) by writing off goodwill immediately to reserves some companies show a severe reduction of net worth or even an excess of liabilities over assets while continuing to show profits and appear to prosper, especially where goodwill represents a large portion of the acquired assets;

(b) when goodwill is written off immediately it is difficult for users of the financial statements to keep track of the resources spent by management on acquisitions and to determine whether adequate returns on investments are being achieved; and

(c) the calculation of the profit or loss on the sale of a previously acquired business will be misleading if goodwill relating to it had been written off (Njeke, 1991:189).

Price Waterhouse (1990), in their official response to ED47, concluded as follows:

> "To write it (goodwill) off against reserves, as is the current practice, seems to us to lead to an unrealistic view of the financial position of an acquisitive group and to distort any meaningful assessment of management's performance in utilising the economic resources of the business and in earning a return on capital expenditure."

Wilmot (1989:89) suggested that, as goodwill is a payment made in anticipation of future earnings, it is difficult to justify the argument that goodwill should be written off immediately unless factors have come to light confirming that the price paid for goodwill was excessive.

Beyer (1969:12) questioned the immediate write-off of goodwill on the grounds that, if goodwill can be "...summarily disposed off immediately..." after disbursing valuable shareholders' funds for its acquisition, the same argument should hold true for other assets such as plant and equipment on the grounds that the annual depreciation is "...both difficult to estimate and unpalatable."

The proponents favouring this method should be questioned why a valuable asset such as goodwill, for which a substantial amount has just been paid for, should be written off immediately (Everingham & Hopkins, 1982, Service 13:235). Archer (1994:91) stated that any significant write-off of goodwill in the year of acquisition may indicate an overpayment which would validly bring into question the decision to acquire it.

A further argument put forward by the supporters of this method is that, by capitalising purchased goodwill and amortising it, it is inconsistent with the treatment of internally generated goodwill which is written off in the year the expenses are incurred. SSAP22, states this as the principal reason why this method is preferred to the capitalization and amortisation option. SSAP22, paragraph 6, states the following:

> "Thus, if purchased goodwill is treated as an asset whilst non-purchased goodwill is not, a balance sheet does not present the total goodwill of a company (or group); it reflects only the purchased goodwill of the acquired business(es) at the date of acquisition, to the extent that it has not been written off."

The argument that the nature of purchased goodwill and internally generated goodwill is principally the same is theoretically correct as was con-

cluded in Chapter 2. The main difference between the two is, however, the fact that one, purchased goodwill, can rightfully be recognised in the balance sheet as it had a cost attributed to it at the time of its acquisition while internally generated goodwill cannot be recognised as it does not meet the criteria for recognition in a cost-based accounting model because neither its cost nor the transaction or transactions which gives rise to its creation can be identified.

A further argument used in supporting the immediate write-off of goodwill is that goodwill is usually worthless in a forced liquidation. This argument can be discarded on the grounds that accounts are being prepared on the going concern basis and not on a liquidation basis and hence assets such as goodwill should be valued at cost.

The main arguments for writing off goodwill against reserves at the date of acquisition can therefore be summarised as follows:

(a) goodwill is not an asset as it cannot be realised separately from the business and hence represents a once-off payment related to an acquisition and should be eliminated from the balance sheet immediately on acquisition;
(b) the immediate write-off of goodwill to reserves is consistent with the accepted practice under the historical cost income model of not recognising internally generated goodwill in the accounts; and
(c) goodwill is usually worthless in a forced liquidation.

5.4 SHOW GOODWILL AS A DEDUCTION OFF SHAREHOLDERS' EQUITY

This method, sometimes referred to as the so-called 'dangling debit' method, shows goodwill as a deduction off shareholders' equity. The main arguments of those favouring this method are basically the same as those favouring the immediate write-off of goodwill to reserves. Goodwill, according to them, is not an asset in the accepted sense of the word.

Goodwill is made up of unidentifiable items and cannot be valued objectively. Goodwill arises theoretically as a consequence of the accounting conventions adopted and should therefore be disclosed in such a way as to balance the accounts and should not result in any accounting entries such as immediate write-off or amortisation (DP3, 1982:8).

Catlett & Olson (1968:106) also recommended this method as an alternative to the direct writing off of goodwill to reserves as they believed that goodwill represents a disbursement of existing resources in anticipation of future earnings and as such represents a disbursement of shareholders' equity.

A refinement of the dangling debit method of accounting for goodwill was given by the Accounting Standards Board in the United Kingdom in their discussion paper, **Goodwill and Intangible Assets**, issued in 1993. In this discussion paper the so-called separate write-off reserve was proposed as an alterative to the immediate write-off to reserves. Under this method, goodwill is transferred immediately on acquisition to a separate reserve, with a debit balance, labelled the "goodwill write-off reserve' while the shareholders funds are shown in total both before and after inclusion of this reserve.

This discussion paper listed the rationale for this specific treatment of goodwill as follows:

(a) the amount spent on goodwill should be clearly highlighted so that users of accounts can make their own assessment of the success or otherwise of acquisitions. The provision of reliable data relating to the continuing value of goodwill is deemed to be so intricate that it is not attempted;

(b) it is appreciated that the benefits giving rise to purchased goodwill are similar in nature to assets, but it is believed that the difficulty involved in the measurement of those benefits is such that it is

inappropriate to show them as assets in the balance sheet; and

(c) consistency with the treatment of internally generated goodwill is largely achieved as neither is shown as an asset.

As both these methods, the dangling debit and the goodwill write-off reserve, do not recognise the asset nature of goodwill, it is rejected on the basis that goodwill is indeed an asset and should be treated as such. It is further rejected on the basis that although conceptually there is no difference between purchased goodwill and internally generated goodwill, it is only the cost basis of accounting preventing inherent goodwill of being recognised in the financial statements. Therefore the argument that because internally generated goodwill is not recognised, purchased goodwill should also not be recognised is not theoretically acceptable.

5.5 AMORTISE GOODWILL OVER ITS ESTIMATED USEFUL LIFE

While all the previous methods of the subsequent treatment of goodwill have been dismissed as conceptually unsound, the only method that satisfies the conceptual nature of goodwill is to capitalise goodwill and then to amortise it over its estimated useful life.

In this method goodwill is properly treated as an asset, although different in character from other assets, and as such goodwill ultimately represents a payment for future earnings and should thus be amortised against those future earnings. This is also the recommended method prescribed by IAS22 of the International Accounting Standards Committee, APB17 in the United States of America, CICA 1580 in Canada, AASB 1013 in Australia, SSAP-8 in New Zealand as well as the alternative method of SSAP22 in the United Kingdom.

Various arguments used in dismissing the standpoints of not amortising goodwill or for writing goodwill off to reserves are in actual fact argu-

ments in favour of the viewpoint to amortise goodwill and will not be repeated in detail in this section. Conversely, arguments put forward for the retainment of goodwill as an asset indefinitely or for writing it off to reserves at acquisition are arguments against amortisation of goodwill and will likewise not be repeated in detail in this section.

The primary argument used by the advocates of amortising goodwill is that the purchased goodwill represents a cost used up in the production of the excess earnings upon which the payment for goodwill is based. IAS22 states that goodwill "...represents a payment made by the acquirer in anticipation of future economic benefits." (IAS22, par. 41). Paul Rutteman (1987:32) stated that amortising goodwill would "...reflect the reality that the price paid for another company is dependant on the perceived value of the intangible asset of goodwill, and that the intangible asset represents a cost used up in earning additional profits, and that the cost (amortisation) and the profits should both be reflected in earnings per share." Walker (1953:213) stated that "In accordance with a primary function of accounting to match costs and incomes, the cost of purchased goodwill should be amortised as a means of matching the cost of securing the income against the income actually received."

This method also recognises the fact that the goodwill purchased has a limited life not subject to accurate estimation (Everingham & Hopkins, 1982, Service 13, 1989:232). The argument here is that purchased goodwill is gradually being replaced by internally generated goodwill and that the purchased goodwill should be eliminated from the books of account to the extent that the benefits accruing from the acquired goodwill had been realised. Alternatively stated, goodwill should be written off over the estimated period that the firm had been benefitted from the purchased goodwill.

Gilbert (1972:195) stated that it seems reasonable to assume that pur-

chased goodwill, in most cases where the excess earnings continue, has been replaced by internally generated goodwill created through the efforts and skill of the new management team. Due to changing circumstances and new discoveries, it is doubtful if purchased goodwill ever exists in perpetuity, except perhaps in a situation of imperfect competition. The conclusion drawn is thus that the original goodwill acquired should be written off over its estimated useful economic life.

The arguments put forward by those who favour the amortisation of goodwill are conceptually sound. This conclusion is based on the line of reasoning which starts with the theory that a payment for goodwill theoretically represents the present value of the excess earnings accruing to a new owner as a result of the momentum of the earning power, caused by various intangible factors, at the time of the acquisition. Such a concept essentially suggests a limited life of the actual acquired intangible factors comprising goodwill. As accounting is basically a process of matching costs, in the historical cost context, against those revenues for which they can reasonably be responsible, the cost of purchased goodwill should rightfully be matched against the excess revenues which it is expected to realise. Such matching can be accomplished by the periodic amortisation of goodwill to income in the periods presumably affected (Emery, 1951:564).

When establishing the time period over which goodwill should be amortised, due consideration should be given to the amount and timing of the economic benefits to be derived from the intangible factors comprising goodwill. For proper matching of expenditure on goodwill to the revenue it relates to, goodwill should be amortised over the estimated period during which the associated benefits are expected to be received. To achieve this proper matching, separate assessments should be made regarding the different goodwill components to the extent that such components are evident (AASB 1013).

Estimating the life of purchased goodwill is one of the more difficult aspects of the amortisation of goodwill. Gilbert (1972:197) stated that "Estimating the life of goodwill would be more difficult than estimating the life of a building or machine, because it could not be based on past experience or on an engineer's calculations."

IAS22, APB17 and AASB 1013 listed various factors that should be taken into account when estimating the estimated useful life of goodwill. These include:

(a) the anticipated future of the business or industry;

(b) the effects of product obsolescence, changes in demand and other economic factors;

(c) the service life expectancies of key individuals or groups of employees;

(d) expected actions of competitors or potential competitors; and

(e) legal, regulatory or contractual provisions affecting the useful life of goodwill.

Curran (1989:57) highlighted an important point relating to the estimated useful life of goodwill. She stated that it should be remembered that management when making the acquisition in the first place has presumably been able to substantiate the purchase price of goodwill and that it is difficult to believe that management select figures at random in establishing buying prices for shares. She further stated that:

> "...the negotiation process in which they are involved in making business acquisitions is the culmination of an informed assessment of the future benefits available from the assets to be acquired. By reference to the same economic guidelines that justified the purchase of that amount of goodwill, the appropriate amortisation policy is implied."

Becker (1990:8) felt that an objective evaluation of the expected useful life of goodwill as well as the amortisation method used would normally

result in a relative short period of amortisation. He further suggested that notice should be taken of (a) the time it would take to start a new business from afresh to the stage of profit earning at the acquisition date and (b) how fast the excess earnings (and therefore the purchased goodwill) would decline if expenditure on inherent goodwill was not sustained. Russel (1989:23), in a research report, concluded that the amortisation period should be determined on a prudent basis and include only those years actually benefitting from the goodwill.

Regarding the method of amortisation, the systematic amortisation using a straight line basis is the method recommended by IAS22, APB17, CICA 1580, AASB 1013, SSAP-8, and SSAP22, the only difference being the recommended period and the maximum period set by these different standards. IAS22 recommend a period of five years with a maximum period of twenty years, APB17 and CICA 1580 set a maximum period of forty years, AASB 1013 set a maximum period of twenty years, SSAP-8 recommend a period of ten years but set a maximum period of twenty years while SSAP22 does not set any maximum period.

Everingham and Hopkins (1982, Service 13, 1989:232) also favours the systematic basis of amortisation of goodwill, but recommend the application of the sum of the digits method to the period benefitted from the acquisition. Their argument is that this is likely to result in a fairer matching of revenues and expenses, since under the present value method of determining goodwill, super profits are largest in the first year. They further recommend that this method should be coupled with an annual review of actual profits versus anticipated profits thereby recognising both the matching and prudence concept. In Australia recently, certain companies tried to minimise the effect of amortising goodwill in the earlier years of the life of goodwill by using the inverse sum of the years digits (ISYD) method to amortise goodwill (Mackenzie, 1995:44) but met with stiff opposition from the Australian Securities Commission, backed

by the Australian Society of Accountants, based on the argument that the period of benefit from purchased goodwill is more in the first couple of years after acquisition as opposed to later years. The ISYD method, according to Mackenzie (1995:45), does not properly reflect the loss of service capability of the acquired goodwill, which decreases with the transition of time reflecting its diminished capability to contribute to the future cash flows of the undertaking.

The Accounting Standards Board in the United Kingdom, in its discussion paper, **Goodwill and Intangible Assets,** suggested an alternative to the systematic amortisation of goodwill which is called the "capitalization and annual review' method. Under this proposed method goodwill is capitalised and then amortised over its useful economic life through the application of a formal annual recoverability review that determines the appropriate amortisation charges by ascertaining any impairment in the related investment. The annual review is performed by using so-called ceiling tests whereby the net present value of the investment is estimated and compared with the sum of the fair values of the individual assets, liabilities and goodwill. Reductions in the recoverable values attributable to assets and liabilities are adjusted against such assets and liabilities while reductions in the recoverable amount not attributable to any recognised assets or liabilities of the investment must, by default, be attributable to the goodwill purchased with the investment. These tests may in some periods give rise to no amortisation but under no circumstances may goodwill be adjusted upwards.

This method, however, is conceptually unsound as these so-called ceiling tests are in actual fact valuing a mixture of the remaining purchased goodwill and internally generated goodwill. These ceiling tests may continue to show a value of the mixture long after the life of the purchased goodwill has expired (Myddelton, 1994:90).

There seems to be general consensus by those favouring the amortisation of goodwill is that the amortisation should be done as an operating expense through the profit and loss account. This is based on two arguments:

(a) as purchased goodwill is a cost incurred in securing a stream of future excess earnings, the cost should be matched in the ensuing years with those excess earnings reflected as revenue in the profit and loss account; and

(b) as expenditure on internally generated goodwill is charged to the profit and loss account, consistency requires that the amortisation of purchased goodwill should also be charged to the profit and loss account.

Apart from the fact that it is conceptually unsound, Statement AC103 (par .11) effectively disallows the writing off of goodwill as an extraordinary item in South Africa as it clearly states that:

> "Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item."

It is contended therefore that the writing off of goodwill, even in a lump sum, does not satisfy the requirements of an extraordinary item in the revised statement AC103 as goodwill is not an "expense that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise..."

The arguments in favour of the amortisation of goodwill can thus be summarised as follows:

(a) goodwill is an asset as it represents various intangible factors contributing to the firm's earning capacity providing returns in excess of normal returns on assets employed;

(b) goodwill has a limited life as the goodwill purchased is highly volatile and is constantly being replaced by internally generated goodwill;

(b) by amortising goodwill, compliance to the matching concept is achieved as the goodwill purchased, ultimately representing a payment for expected future excess earnings, is matched with those future excess earnings.

5.6 WRITE OFF GOODWILL TO SHARE PREMIUM

This method is only found where there has been an acquisition based on a share-for-share exchange. The supporters of this approach argues that where shares are exchanged in a purchase transaction, shares issued at their market value may include an element of the issuing company's inherent goodwill in their market price. This element of inherent goodwill will then be reflected in the share premium account, or if no par value shares have been issued, in the stated capital account (Everingham & Hopkins, 1982, Service 13, 1989:230).

This method also seems to be justified by the wording of Section 76 (2) of the Companies Act No. 61 of 1973 which provides as follows:

> "Where assets are acquired by the issue of shares of a company and no consideration is recorded, the assets so acquired shall be valued and if the value of the assets is more than the par value of such shares, the difference between the par value of the shares and the value of the assets so acquired shall be transferred to the share premium account."

Section 76 (2) thus makes it possible for goodwill, in a share-for-share-exchange, only to be recognised where it is specifically recognised and valued as one of the assets taken over, effectively allowing goodwill to be set off against share premium where this is not the case (Wixley, 1974:303)

Sections 83 and 84 of the Companies Act also effectively allows goodwill to be set off against share premium (practically part of share capital) and share capital, particularly in the case of capital reconstruction schemes.

The setting off of goodwill against share premium or share capital is however conceptually unsound as no support in the literature could be found for justifying this treatment (Everingham & Hopkins, 1982, Service 13, 1989:230).

5.7 SUMMARY AND CONCLUSIONS

In Chapter 2 it was concluded that goodwill is an asset and therefore its appropriate treatment should be evaluated from that point of view. Assets are normally retained at its original cost, written down to its market or realisable value or amortised over its estimated useful life.

The permanent retention of goodwill as an asset has been dismissed on the following grounds:

(a) goodwill is an asset representing future economic benefits in the form of future excess earnings and hence the cost of purchased goodwill should be amortised against those excess earnings;

(b) purchased goodwill is constantly being replaced by inherent goodwill; therefore the value of purchased goodwill diminishes over time and hence should not be retained at its original cost;

(c) although the total value of goodwill may be retained by expenditure, the original cost of the purchased goodwill should be matched, by amortisation, with the related excess earnings.

The writing off of goodwill against reserves or shareholders' equity at the date of acquisition has also been dismissed on the grounds that:

(a) goodwill is conceptually an asset and cannot rightfully be written off against reserves or retained income at the date of acquisition;

(b) by capitalising purchased goodwill, it is not claimed to represent the total goodwill value of the business or the group, but only the goodwill pertaining to the acquisition representing a cost to be allocated over the expected useful life of the acquired goodwill.

The capitalization of goodwill and its systematic amortisation over its estimated useful life is the only theoretically correct method of accounting for goodwill for the reasons stated earlier in this Chapter.

Estimating the useful life of goodwill is likely to be difficult, but should not be used as a reason for not amortising goodwill. As the intangible factors constituting goodwill, and thereby their useful lives, may differ from company to company, it seems appropriate not to specify a maximum or minimum period of amortisation. The actual profits should be compared with the expected profits and any adverse deviation should be reflected in a revised estimation of the useful life of the purchased goodwill to recognise the prudence concept (Everingham & Hopkins, 1982, Service 13:232).

Amortisation charges should be debited to the profit and loss account to effect proper matching with expenses due to the fact that the excess earnings against which the purchased goodwill should be amortised is reflected as income in the profit and loss account.

Goodwill should be disclosed in the balance sheet as an asset under fixed assets at its original cost less the aggregate of the amortisation charges to date. The gross amount of goodwill should be stated with the aggregate goodwill amortised to date shown separately (Everingham & Hopkins, 1982, Service 21, 1993:238). Goodwill on consolidation, which is being amortised, will cause the holding company's reserves to differ from that of the group but it is conceptually sound as the holdings company's investment is in the shares of the subsidiary and not in the individual

assets and liabilities of the subsidiary (Everingham & Hopkins, 1982, Service 13, 1989:236).

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CHAPTER 6

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

The primary objective of this research study was to critically evaluate the current accounting treatment of purchased goodwill in terms of a conceptually sound theoretical framework. To achieve this objective a comprehensive literature study of both the construction of accounting theory as well as accounting for goodwill, intangibles and business combinations was undertaken.

6.2 SUMMARY OF THE RESEARCH

In Chapter 2 a theoretical framework for goodwill was established, including a conceptual study of the true nature of goodwill. This investigation into the true nature of goodwill included an evaluation of the existing conceptions of goodwill such as the super-profits concept, the residuum concept and the intangibles concept. Using a normative approach the theoretical treatment of purchased goodwill was approached from the viewpoint of how goodwill ought to be treated based on its underlying nature. The relationship between the earning capacity of the undertaking and the various intangible factors causing this above average earning capacity and goodwill was examined. In the process of examining the nature of goodwill, an investigation into whether goodwill could properly be regarded as an asset and be rightfully included in the balance sheet was also carried out. Also in this chapter the measurement and valuation of goodwill was investigated under the traditional historical cost income model with a very limited investigation into accounting for goodwill under the current cost, the realisable value and the present value bases of asset

valuation. This chapter also dealt with the question of so-called negative goodwill where the fair value of the identifiable assets acquired exceeded the purchase price. Inherent or internally generated goodwill was covered to a very limited extent as it did not fall within the scope of this research study.

The historical development of the goodwill concept as well as the actual treatment of purchased goodwill over the years have been addressed in Chapter 3. This included the early legal definitions of goodwill as well as the different conceptions of goodwill mentioned above. A comprehensive examination of the current status of accounting standards on goodwill, and its development over the years, in all the major English speaking countries was carried out in Chapter 4.

Using all three prediction levels of theory, the theoretically correct treatment of goodwill was investigated in Chapter 5. At the structural level the capitalization of goodwill and its systematic amortisation and the direct write-off of goodwill against reserves were evaluated. At the interpretational level the carrying of goodwill as a permanent asset and its write-off only in the case of a permanent diminution in its value, was evaluated. On the behavioural level the disclosure of goodwill in the annual financial statements was examined.

6.3 CONCLUSIONS

The major conclusions reached in this research study can be summarised as follows:

(a) Two of the major current conceptions of goodwill, namely the super profits concept and the residuum concept of goodwill, which are often given as definitions of goodwill, do not properly define the nature of goodwill but rather are methods of measuring and valuing goodwill.

(b) An amount paid by an acquiring company over the net asset value of identifiable tangible and intangible assets does not always represent goodwill in the theoretical sense but can include payments for assets above its net asset value, payments to obtain control of the undertaking or simply an overpayment for the net assets acquired. In the case of an overpayment this loss should be written off immediately.

(c) A payment for goodwill has a direct link to a firm's ability or capacity to earn profits in excess of a normal return on assets employed.

(d) A firm's ability to earn profits in excess of a normal return is caused by various intangible factors present within the undertaking. These various intangible factors differ from firm to firm but can include items such as a superior management team, harmonious labour relations, favourable location, unique production process, a good business reputation, established clientele etc.

(e) Goodwill therefore consists of several intangible factors whose presence in an undertaking is closely linked to it's ability to produce above average returns and that, in the process of another undertaking acquiring this undertaking, it is willing to pay an amount in excess of the fair value of the net identifiable assets for these intangible factors causing these above average returns.

(f) As goodwill represents a payment for various intangible factors within an undertaking, it ultimately represents a payment for expected future excess profits. It thus satisfies the requirements to be classified as an asset namely that it represents expected future economic benefits (2) controlled by the undertaking (3) resulting from a past transaction.

(g) Goodwill is an intangible asset as its basic components are various other intangible assets thus complying to the requirements of an intangible asset as having no physical existence and which value is limited by the right and future benefits that possession bestows

to the owner.

(h) Goodwill, being an asset, should be recorded under the historical cost income model at its acquisition cost, measured as the difference between the total purchase price and the fair value of the net assets acquired after ensuring that all assets, both tangible and intangible, have been identified and fairly valued thereby assuring that the balance of the purchase price represents actual goodwill.

(i) As purchased goodwill represents the probability of future economic benefits flowing to the enterprise and its cost can be measured with reliability, being the acquisition cost at the date of acquisition, it can rightfully be included as an asset in the financial statements within the requirements of the conceptual framework for financial reporting.

(j) Where the fair values of the net assets acquired exceeds the purchase price and so-called 'negative goodwill' arises, this represents a bargain purchase. This excess should be proportionately applied to reduce the fair value of the non-monetary assets to its actual cost. If the excess so applied reduces the cost of the non-monetary assets to zero and a balance remains, it should be treated as deferred income and taken to income over the period estimated to be benefitted from.

(k) Goodwill has a limited life which is not subject to accurate calculation. Purchased goodwill is constantly being replaced by internally generated goodwill and the estimation of the useful life should be based on the extent to which the benefits accruing from the goodwill purchased is being realised.

(l) Having a limited life and representing future excess profits, goodwill should be amortised against those excess future profits over the estimated period during which the associated benefits from the acquired goodwill are expected to be received in order to effect proper matching between revenue and expense.

(m) Goodwill should be amortised on a systematic basis over its esti-

mated useful life.

(n) Goodwill amortisation charges should be written off in the profit and loss account to effect proper matching of revenue with expense as the excess profits against which purchased goodwill is to be amortised are reflected as income in the profit and loss account.

(o) Goodwill should be disclosed in the balance sheet under fixed assets at its original cost less the aggregate of the amortisation charges to date. The basis on which goodwill is being amortised should be disclosed in terms of generally accepted accounting practice.

(p) There is no difference in character between purchased goodwill and inherent goodwill, the only difference is that, in the case of purchased goodwill, the value is determined, although on a subjective basis, as a fact at a particular point in time by a market transaction while this is not true of non-purchased goodwill. Under the historical cost basis, however, and in terms of generally accepted accounting practice, inherent or internally generated goodwill should not be recorded in the financial statements of a company due to the absence of a generally accepted objective method of measurement. Expenses in generating or sustaining inherent goodwill should be written off in the profit and loss account in the year incurred.

6.4 RECOMMENDATIONS

The main recommendations flowing from this research study are:

6.4.1 Accounting treatment of goodwill in South Africa:

It is recommended that the method found by this research study to be the most conceptually sound accounting treatment of goodwill be advocated as the only acceptable method in South Africa. This method comprises the

capitalization of purchased goodwill and its systematic amortisation over its estimated useful life and can be summarised as follows:

(a) under this method purchased goodwill is defined as an intangible asset, inseparable from the business as a whole, representing various intangible factors contributing to the enterprise's earning capacity and providing returns in excess of a normal return on assets employed, for which an acquiring enterprise is willing to pay an amount in excess of the fair value of the identifiable net assets acquired;

(b) purchased goodwill should be recorded at cost measured by the difference between the purchase price and the fair value of the net identifiable assets acquired after ensuring that all assets, both tangible and intangible, have been identified and valued;

(c) purchased goodwill should be amortised on a systematic basis against profits over the estimated period during which the associated benefits from the acquired goodwill are expected to be received; and

(d) where the fair values of the net assets acquired exceeds the purchase price this represents a bargain purchase and should be proportionately applied to reduce the fair value of the non-monetary assets to its actual cost. If the excess so applied reduces the cost of the non-monetary assets to zero and a balance remains, it should be treated as deferred income and taken to income over the period estimated to be benefitted from. The term 'negative goodwill should be avoided.

6.4.2 Setting a generally accepted standard in South Africa

It is recommended that the South African Institute of Chartered Accountants initiates the process of establishing a Statement of Generally Accepted Accounting Practice on the accounting treatment of purchased goodwill in order that South African accounting practices on goodwill are standardised and brought into harmony with international accounting practices.

In the interim it is recommended that the provisions of the International Accounting Standards Committee's statement on Business Combinations, IAS22, be used as the recommended treatment of purchased goodwill by South African companies.

6.4.3 Areas for further research

During the course of this research study the following areas have been identified which needs further research:

(a) **Balance sheet recognition of inherent goodwill:**
As it has been concluded that conceptually there is no difference in character between purchased goodwill and internally generated goodwill its seems necessary to research whether there are any conceptual grounds for the balance sheet recognition of internally generated goodwill. This seems necessary because there seems to be an anomaly in that the same asset, intrinsically the same in character, is treated from an accounting viewpoint in two different and opposing ways.

(b) **Tax deductibility of goodwill amortisation charges:**
Although not an accounting problem but rather a taxation problem it seems appropriate, taking the true nature of goodwill into account, that there is a case to be made out for the deduction of goodwill amortisation charges against taxable income. It seems to be incorrect that the excess earnings received should be subject to taxation but that the expense incurred in producing these excess earnings, namely purchased goodwill, is not allowed as a deduction off these excess earnings.

(c) **Treatment of goodwill under non-conventional income models:**
The treatment of purchased goodwill under the historical cost in-

come model has been researched intensively but there seems to be a general lack of research into the accounting treatment of goodwill under any of the other non-conventional income models. This is probably understandable as the measurement basis most commonly used by companies in preparing financial statements is still historical cost.

(d) Alternative amortisation methods:

Research needs to be undertaken to examine the relationship between the relative size of the annual excess returns and the estimated period over which these excess earnings can be expected to be realised. It seems unlikely that excess earnings are earned in 'equal annual instalments' requiring amortisation on a straight line basis. Maybe alternative amortisation methods such as the sum of the digits method needs to be considered if it can be empirically proved that the excess earnings are larger in the earlier years than in the later years during the period benefitted from the acquisition of the goodwill.

6.5 CLOSING REMARKS

Is the appropriate accounting for goodwill, an elusive panacea or never-ending story? This research study has, hopefully, contributed to the proper identification of what goodwill really is and how it should properly be accounted for in the financial statements. It is hoped that the accounting profession internationally finally decide on one accounting treatment for goodwill which is conceptually sound and finally ends one of accounting history's most belligerent chapters - Accounting for Goodwill.

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