The concepts of goodwill accounting

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Abstract—The paper “The concepts of goodwill accounting” analyzes and compares several problems arising from accounting techniques concerning goodwill according International Financial Reporting Standards or Generally Accepted Accounting Standards of the United States of America. It is concentrated on evaluation of the harmonization level between these two Standards and in cases where these standards differ it tries to suggest the better solution for the selected problem. At the beginning it is oriented on the definition of goodwill in both Standards that is unfortunately not very precisely stated. On the contrary the way of its value calculation is defined very well. In the next chapters is emphasized that there is precise differentiation between accounting for goodwill existing and/or acquired in course of entity’s ordinary business activity and the ones acquired in course of a business combination. And because this segregation is expected in the rest of this paper the accounting procedures concerning goodwill identification, useful life, amortization and connected values (carrying amount, recoverable amount, fair value and the amount of net consideration transferred) are studied from this points of view too. Last but one chapter is interested in impairment of goodwill and in the end there are particular gained knowledge generalized into final conclusions.

Keywords—goodwill; US GAAP; IAS; IFRS; accounting standards; impairment

I. INTRODUCTION

Currently international accounting and reporting for goodwill represents one of the most disordered and debated among academicians and practitioners topics in accounting. And it represents the matter of particular consideration in field of accounting for business combinations. Nevertheless despite all the existing call for harmonization and streamline of US GAAP and IAS/IFRS accounting for goodwill and its subsequent impairment in general and for business combinations in particular little progress has been done. For today the whole history of initiation and further development of international accounting for goodwill and its impairment may be summarized in adoption of two accounting standards - FAS 142 and IAS 36 in the year 2001. However in regard of US GAAP here it should be stated that certain further efforts to improve the existing authoritative basis have been done. It was introduction of accounting standards update for FAS 142 in 2011 designed to facilitate the goodwill testing procedure to give both public and non-public entities the possibility to determine whether they can bypass the two-step goodwill impairment test under relevant authoritative pronouncement. Nevertheless no further improvements e.g. mutual US GAAP and IFRS projects aimed at harmonization and standardization of accounting for goodwill yet have been launched.

II. PROBLEM FORMULATION

A. The Aim of the Paper

The paper “The concepts of goodwill accounting” is aimed firstly to describe particular attitudes arising from International Financial Reporting Standards and US Generally Accepted Accounting Principles and to evaluate the level of existing harmonization in the branch concerning goodwill and its accounting. Secondly there will be found out differences between these two systems at this area and there will be carried out qualitative comparison of US GAAP and IAS/IFRS accounting procedures and reporting for this business phenomenon.

B. Structure

This paper is structured into several main parts. Firstly, after brief introduction, there is stated the aim of the paper including its proper structure. Secondly the paper itself starts with definition of analyzed topic that is goodwill and it continues with conditions for recognition and measurement of goodwill occurring in course of a business combination. Thirdly there are analyzed procedures connected to impairment of goodwill in both standards. In the end there are according to carried out analysis find some conclusions in the area of goodwill based on IAS/IFRS and US GAAP comparison.

III. PROBLEM SOLUTION

The primary sources of regulation of accounting for goodwill are considered to be FAS 142, Goodwill and Other Intangible Assets with its further Update, and IAS 36, Impairment of assets. Both Standards are primary dealing with goodwill occurred in course of a business combination. It means that such accounting is also within the scope of FAS 141 (R), Business combinations, and IFRS 3 (R), Business
combinations. In light of this FAS 142 and IAS 36 are considered to be the primary sources of goodwill accounting while FAS 141 (R) and IFRS 3 (R) are considered to be the secondary ones.

The objective of both Standards is to provide some guidance for entities into proper accounting and reporting of goodwill and other intangible assets. The proper way of accounting is considered to be either in values of so-called “net amount” or in values of “recoverable amount” and “carrying amount”. Although the accounting values somewhat differ still they are assumed to reflect the same substance.

Both FAS 142 and its further Update address to accounting and reporting for goodwill occurred in course of business combination (FAS 142 (par. 4, p. 8) and Update). On the contrary to these standards IAS 36 primarily addresses to accounting and reporting for impairment of assets, the composing part of which is goodwill occurred in course of a business combination that an entity recognizes and measures in accordance with IFRS 3 (R).

A. Goodwill Characterizations

At the beginning it should be stated that there can be found no single and unified definition for goodwill in existing GAAP of the United States of America and IAS/IFRS authoritative pronouncements.

FAS 142 provides rather precise definition for goodwill value as an excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. Further the Standard (FAS 142, Appendix F, p. 105) specifies that such amount includes acquired intangible assets that do not meet the criteria in FAS 141, Business Combinations, for recognition as an asset apart from goodwill. The obvious drawback of such, seemingly full and straightforward definition is lack of interpretation concerning the net amount assigned to assets acquired and liabilities assumed in course of such business deal.

On the contrary to this the term of goodwill is defined far less precise. While addressing to goodwill IAS 36 gives the interpretation of impairment loss which, in fact, is the opposite phenomena to goodwill. Thus goodwill can be identified as the amount by which the recoverable amount of an asset or cash-generating unit (i.e. the higher of asset’s or unit’s fair value less costs to sell and value in use) acquired in course of business combination exceeds its carrying amount (i.e. the amount at which an asset is recognized after deducting any accumulated depreciation/amortization and accumulated losses thereon - IAS 36, par. 6, p. 9). In such interpretation the concept of fair value is preserved, at least in minimum extend. The only drawback is that such definition is not the direct one, but derived from the opposite concept.

The further study of other relevant authoritative pronouncements i.e. FAS 141 and IFRS 3 (R) find the nearly identical definition of goodwill, which is based on its view as the value of potential benefits which can be in the future generated by such intangible asset. Further both Standards introduce the condition for such asset to be recognized as goodwill. It is impossibility of being individually identified and separately recognized. And subsequently there are represented the criteria for recognizing an asset as identifiable one and, thus, as goodwill:

- the asset can be separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or
- the asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (FAS 141, par. 3j-3k, p. 2 and IFRS 3 (R), par. appendix A, p. A152).

Although likewise in case of one of primary sources of authoritative pronouncements for goodwill accounting the concept of fair value is dropped here it has two major advantages. First of all, the approach considering the value of future benefit is among the most progressive ones. Secondly, the extent to which the concept of goodwill is harmonized and unified within both sets of international accounting standards is remarkable. In fact, the latter is considered to be one of the largest achievements of FASB and IASB Business combinations project in course of which both Standards have been introduced.

B. Goodwill recognition and measurement

Goodwill technically stands for a non-impairable difference between recoverable amount and (adjusted for fair value) carrying amount of certain assets, which are non-divisible from cash-generating/reporting units. (FAS 142, Appendix F, p. 105 and FAS 141, par. 3j-3k, p. 2; IAS 36, par. 6, p. 9 and IFRS 3 (R), par. Appendix A, p. A152). Thus for its identification, recognition and measurement it is necessary to go in reverse way. First of all the identification of non-impairable assets or their senior units should be performed than measurement of fair value of such assets or units should be conducted. Finally, goodwill is determined.

Here it should be stated that there is precise differentiation between accounting for intangible assets, including goodwill existing and/or acquired in course of ordinary business activity of entity and the ones acquired in course of a business combination. The accounting for the first case is subject of regulation of FAS 142 (including its Update) and IAS 36, while the second case is within the scope of FAS 141 (R) and IFRS 3 (R). Such differentiation will be preserved in this paper.

In general the accounting approaches applied in case of ordinary activity and a business combination are rather similar although there are some small differences. In both cases it is required to:

- recognize assets for which subsequently goodwill will be identified;
- measure adjusted fair value amount;
- identify goodwill or loss;
- decide on impairment.
The major difference is the direct application of fair value measurement instead of calculation the carrying amount with further adjustment for fair value while accounting for goodwill in case of business combination. Also not the recoverable amount within a business combination is determined but the so-called “purchase price”, which is considered to reflect the same substance as the recoverable amount is used to do. And, the last difference lies in concept of negative goodwill i.e. loss. In a business combination it is defined as bargain purchase.

C. Ordinary business activity

When we consider accounting for goodwill within ordinary business activity first of all the non-impairable assets should be determined.

1) Identification of non-impairable assets

None of two sets of Standards provide a direct way how non-impairable assets should be identified. There is only guidance for impairable ones. In light of this it is necessary to go from the opposite i.e. first all impairable assets are determined and what is left is considered to stand for non-impairable ones.

There are two ways for determination the impairable assets. They are defined:

- through capability of an individual (impairable) asset to generate future cash flows, and in case if it is impossible
- through such capability of cash-generating or reporting unit to which such individual asset belongs.

2) Useful life, amortizability and non-amortizability

One way for recognition and measurement of value of future cash flows generated by either an individual asset or by the superior unit to which it belongs is through application the criterion of the so-called “useful life” of an individual asset (FAS 142, par. 11, p. 10 and IAS 36, par. 7-17). Determining or non-determining the useful life of an individual impairable asset leads to its recognition as amortizable or non-amortizable one. Both FAS 142 and IAS 36 agree on this criterion. However, if FAS 142 has quite straightforward formulation of it, IAS 36 due to its focus on overall substance rather than direct principle has more vague definition of it.

The concept of useful life may stand for a wide variety of factors, for instance:

- activity based use of an asset and/or the derivative asset (or group of assets) for which the individual asset is the underlying;
- any legal, regulatory and/or contractual contingent limitations;
- macroeconomic and/or microeconomic environment;
- other contingencies.

3) Carrying amount

After deciding on amortizability or non-amortizability of an individual impairable asset the following operations are carried out:

- in case of amortizable asset its initial and residual values are calculated, and their difference is subsequently amortized;
- determination of carrying amount as either difference between initial value and amortizable value or just initial value when non-amortizability is the case;
- measurement of recoverable amount.

Such approach is common for both sets of Standards.

4) Recoverable amount

For every intangible asset the recoverable amount should be determined. If it is impossible that the recoverable amount of operating unit to which the individual asset belongs should be determined. This is the point of view represented in IAS 36. Similar logic is pursued in FAS 142 although in a bit different way. It requires determining the fair value and purchasing price for each assets or operating units comprising such assets.

Recoverable amount of an asset can be identified as highest amount at which an asset can be exchanged knowledgeable, willing parties in an arm’s length transaction less transaction costs and its value in use. This interpretation is given in accordance with IAS 36, IFRS 13 and FAS 141. Opposite to this FAS 142 uses the term fair value, which in fact reflects the same substance with an exception of non-deducting the value in use from its total amount.

Here it should be stressed that measurement of recoverable amount is carried out for all assets regardless of their impairability or non-impairability. After recoverable amount of all assets has been measured it can be compared with carrying amount of all impairable assets and, hence, goodwill or loss can be identified. The amount received should be further tested for impairment. Loss should be amortized while goodwill should not (FAS 142, par. 18-22, p. 12-13, IAS 36, par. 58-64).

D. Business combination

In case of a business combination the amount of goodwill is determined through comparison of fair value of assets acquired in a course of such deal with net value of consideration transferred less tax benefit.

1) Fair value

Likewise in case of goodwill accounting within ordinary activity the recoverable amount is measured. It is named as fair value. Both FAS 157 (par. 5, p. 2) and IFRS 13 (par. appendix A, p. 32-33) define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The main conditions for such price are the existence of most advantageous market and market participants, meeting the requirement of highest and best use, and application of special valuation techniques.

It is necessary to stress that fair value measurement is part of another system of principles designed to regulate the accounting for business combinations. Thus the procedure of fair value measurement is rather complex, with many exceptions and particularities. It is an integral part of so-called “acquisition method”, which prescribes the four-step approach
for identification, recognition and measurement at fair values of assets acquired in course of a business combination. And it is necessary to say that within both sets of Standards such acquisition approach and, consequently, fair value measurement does not make any distinctions between accounting for impairable and non-impairable assets acquired in course of such business deal. That is the one of the major differences between goodwill accounting within ordinary activity and within a business combination.

2) Consideration transferred
Opposite to ordinary business activity where the carrying amount is measured in case of a business combination the amount of net consideration transferred is measured.

The calculation of the amount of net consideration transferred is based on calculation of purchase price plus transaction costs less tax benefits. Whereas transaction costs and tax benefit can be identified and measured rather simply, the calculation of purchase price may be a little bit problematic. Its amount is derived from the exchange ratio i.e. the ratio at which the shares of acquired unit are converted into the shares of acquiring unit. The exchange ratio can be determined according to the combining entities’ book values, market values, sales, earnings or some relevant characteristic reflecting the market power of entities. One of the most popular tools used for determination of exchange ratio is model introduced by [13]. That model is based on assumptions about the pre-combination and post-combination earnings streams and P/E (price/earnings) ratios.

Along with purchase price both FAS 141 (R) and IFRS 3 (R) require the net value of the consideration transferred to reflect the fair value of assets acquired, liabilities assumed and equity transferred in course of such business deal.

In light of stated above the purchase price can be determined as the market value of capital shares of combining entities converted into shares issued by acquirer at predetermined exchange ratio.

After the fair value of all assets in course of a business combination acquired has been measured and the amount of net consideration transferred has been identified these two amounts can be compared and there may be derived conclusion on occurrence of either goodwill or bargain purchase. Likewise in case of ordinary business activity such goodwill or bargain purchase occurred in course of a business combination should be further tested for impairment (FAS 142, par. 18-22, p. 12-13, IAS 36, par. 58-64).

E. Goodwill - impairment
Goodwill (loss/bargain purchase) impairment stands for a procedure of testing the goodwill or loss (bargain purchase) occurred in course of both ordinary business activity and a business combination for impairment. If the outcome of the test proves the possibility of impairment than such procedure is conducted. However it is necessary to remind that goodwill is impaired but not amortized while loss is impaired and amortized under both sets of Standards.

1) Impairment test
The impairment test is applied either to an individual asset including goodwill or to cash-generating/reporting unit to which such individual asset belongs. The impairment test is conducted in one stage under IAS 36 and in a sequence of two stages under FAS 142.

Under FAS 142 at the first stage there is performed goodwill allocation and then the goodwill impairment. However there are certain cases when it is impossible to allocate existing goodwill. For this reason the first stage of impairment test comprises two scenarios leading to transition or not transition to the next stage. In fact, it is recognition whether goodwill may or may not be allocated. An entity shall allocate the fair value to all of the assets and liabilities of that unit had been acquired in a business combination. The fair value of the reporting unit was the price paid to acquire the reporting unit. The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is (FAS 142 par. 21, p. 13) the implied fair value of goodwill.

Both IAS 36 and FAS 142 state that for the purpose of impairment the goodwill acquired in a business combination is allocated between each of the cash-generating/reporting units or groups of them, which is expected to benefit from the synergies of the business combination if both of the following criteria are met:

- the asset will be employed in or the liability relates to the operations of a cash-generating unit or reporting unit; and
- the asset or liability will be considered in the fair value of the cash-generating unit or reporting unit.

In the majority of cases goodwill can be allocated but not always. IAS 36 states that sometimes the goodwill may not be distributed (based on criteria that are not arbitrary) between the individual cash-generating/reporting units, but only between groups of them.

The second stage of the impairment test according to FAS 142 and the last operation under the one-stage approach under IAS 36 comprises recognition and measurement of an impairment loss through the comparison of the fair value of an individual asset or a cash-generating or reporting unit to which such asset belongs with its carrying amount, and the measurement of the amount of impairment loss, if any. If loss is recognized, it is further amortized. If there is no loss but goodwill, so it is not amortized.

IV. CONCLUSION
Currently goodwill accounting represents one of the most disordered and debated topics of international accounting. Although particular steps toward harmonization of US GAAP and IFRS goodwill accounting recently have been taken some substantial differences still continue to remain.

The authoritative framework for goodwill accounting comprises FAS 142 with its further Update and IAS 36 as the primary sources, and FAS 141 (R), IFRS 3 (R), FAS 157 and IFRS 13 as the secondary ones. The objective of both sets of Standards is to provide certain guidance for entities in general
and combining entities in particular into proper accounting and reporting for goodwill and other intangible assets. The proper way of accounting is considered to be either in values of net amount or in values of recoverable and carrying amount. Although the accounting values sometimes differ still they are assumed to reflect the same substance.

Currently within existing Standards there is no unified definition for goodwill. Putting all pieces together allows us to define goodwill as non-impairable difference between recoverable amount and (adjusted for fair value) carrying amount of individual assets, which are non-divisible from cash-generating or reporting units and are capable to generate some benefit in the future.

There is rather precise differentiation between accounting for goodwill existing and/or acquired in course of ordinary business activity and the one acquired in course of a business combination. In general accounting approaches applied for goodwill accounting in case of ordinary activity and a business combination are rather similar. Firstly, the assets to which the goodwill belongs are to be recognized then measured at fair values, and, finally, the goodwill or loss is identified and decision about impairment or non-impairment is taken. The major differences lie in the way how two approaches perform the fair value measurement and estimate the value of recoverable amount or purchase price, bargain purchase or loss.

Goodwill (loss/bargain purchase) impairment stands for a procedure of testing the goodwill or loss (bargain purchase) occurred in course of both ordinary business activity and a business combination for impairment. If the outcome of the test proves the possibility of impairment than such procedure is conducted. However it is necessary to remind that goodwill is impaired but not amortized while loss is impaired and amortized under both sets of Standards.

In this paper there was carried out the analysis, comparison and evaluation of procedures concerning goodwill existing and/or acquired in course of ordinary business activity of entity and the ones acquired in course of a business combination as well from the point of view of US GAAP and IAS/IFRS. It has been proven worthy that in the next research the similar topic should be analyzed according to accounting techniques used in the Czech Republic. The comparison with other national and international accounting standards and results originating from such a study could markedly improve fair and true view of the Czech accounting in the area of goodwill and its impairment or amortization.

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REFERENCES