Revised GAAP Treatment for Goodwill

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The Relevance of Goodwill

Goodwill can be informally understood as the price paid during acquisition of an existing business that is above the cumulative net value of all the assets of the acquired business. For example, if the net value of an acquired business’s assets is $1,000,000 but the purchase price of that business is $1,250,000, then “goodwill” would be $250,000.

A more formal definition of goodwill is: “An intangible asset that arises as a result of the acquisition of one company by another for a premium value. The value of a company’s brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology represent goodwill. Goodwill is considered an intangible asset because it is not a physical asset like buildings or equipment. The goodwill account can be found in the assets portion of a company's balance sheet” (Investopedia, 2016).

Any individual or company that acquires another ongoing business operation will be extremely interested in the disposition of goodwill because of the potential effects on the financial statements and ultimate tax treatment for related accounts (Cohn, 2013). The concept of the “time value of money” will also be an important consideration.

Brief History of Goodwill and GAAP

Goodwill made its entrance into accounting during the nineteenth century. In the late 1800s, a business combination or acquisition generally presented the exchange of assets in which the acquired company’s historical (or book value) was less than the value of the cash paid or stock shares issued. In those early instances, the difference was capitalized under the equity heading titled “goodwill.” The inclusion of goodwill was roundly criticized as a form of financial statement management and, “a device of stock watering manipulations: such an item is not merely immaterial, but also imaginary.” ([link](https://basepub.dauphine.fr/bitstream/handle/123456789/2638/fulltext%20EAA2007.pdf)).

Subsequent Major GAAP pronouncements that revised Goodwill Accounting during the twentieth century allowed goodwill accounting to evolve from the abolition of goodwill as a valid accounting treatment into a technique that required the annual analysis for impairment of goodwill. This process could become costly and unwieldy (FASB, 2014).

The New Guidance

The Financial Accounting Standards Board (FASB) revised U.S. generally accepted accounting principles (GAAP) to include alternatives for private companies’ treatment of goodwill. And, FASB Accounting Standards Update No. 2014-02, Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill, permits a private company to amortize goodwill on a straight-line basis over a period of 10 years (Mirea, 2013). Under certain circumstances, another useful life is allowed when it can be demonstrated that it is appropriate.

Conclusion

One alternate method for goodwill states that it should be tested for impairment when a triggering event occurs that indicates that the fair value of the goodwill may have fallen under its current book-value. A private company that elects the impairment alternative must adopt an accounting policy to test goodwill for impairment at the appropriate organizational level.
The other alternative is the amortization method (Cherry-Bekaert, 2015). The relief from the requirement to test goodwill for impairment at least annually is expected to result in significant cost savings for many private companies.

Although the new treatment only extends to private companies for now, FASB also recently decided to add a project to its agenda on the subsequent accounting for goodwill for public companies and not-for-profit organizations (FASB, 2014).

One very interesting related topic for future discussion is the effect that adoption of new goodwill amortization and impairment GAAP policies may have is on the increased use of “earnings management” by organizations. Research indicates that new rules allowing more flexible treatment of goodwill expense dramatically impacts managers’ behavior when presenting financial statements (Caruso, Ferrari & Pisano, 2016).

References


