How Accounting for Goodwill relies on Underlying Assumptions: a Historical Approach

Clémence GARCIA[1]

ABSTRACT

For over 30 years, the role of accounting theory in standard setting has been contested in some countries. This article seeks to provide a better understanding of how theories and their basic assumptions give support to collective accounting choices.
In this paper, we investigate major changes in goodwill accounting in the U.S. over the past century through a literature review. The research is aimed at showing how general assumptions on accounting govern most arguments produced in the debates.
Four different treatments of goodwill have been classified depending on two major assumptions. Then, we analyzed whether the support given to each solution in the literature was consistent with these assumptions. Our findings show that there is a strong link between the dominant views on accounting and the way goodwill is accounted for in each sub-period.

Key Words: *Goodwill, Accounting History*

[1] Meiji Gakuin University, 1-2-37 Shirokanedai, Minato-ku, Tokyo 108-8636 Japan.
E-mail : garcia@eco.meijigakuin.ac.jp

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1. Introduction

All throughout the 20th century, accountants have tried to promote a shared vision of accounting - partly codified in principles or conceptual frameworks - in order to reconcile the conflicting interests of different stakeholders. Paradoxically, the gradual codification of principles revealed an important limit of accounting thought: its contingent nature and obedience to economic circumstances.

In this study, we investigate the set of expectations and basic assumptions towards accounting which forms a common basis for accounting theories. In particular, how do these assumptions govern arguments produced to support a particular accounting treatment ?

The role of underlying theories in collective accounting choices has been suggested by Richard and Colette (2005). As a case study of these considerations, we examine in this research the references to underlying assumptions in goodwill accounting history in the United States.

Some writers[2] argue that the duality of goodwill's definition is a result of competing assumptions towards accounting: emphasis given to the calculation of net worth or given to net income. In the first view, goodwill is seen as an excess earning power, whereas in the second view it is defined as the difference between a company's overall value and the sum of its separate assets. These two conceptions result in quite different accounting treatments for goodwill.

In this development, we tried to show the changes of accounting's underlying assumptions and their impact on goodwill. After proposing a general model of interpretation of collective accounting choices, and an application to goodwill in particular, we investigated the evolution of accounting thought until the publication of SFAS No. 141 and No.142 in 2001.

2. Research Design

After a short presentation of prior research on goodwill history, we submit a simplified model of collective accounting choices as a general framework of interpretation. Then we propose a classification of goodwill's treatments in order to appreciate the extent of a reliance of accounting writers on underlying principles. The following part sets out our analysis on the basis of this framework.

[2] Among others, Colley and Volkan, 1988, Mullen, 1993.

2.1. Prior Studies about Goodwill History

The History of Goodwill and Business Combinations

Hughes (1972, 1982) has investigated extensively American and early British accounting literature from the 1880's to the 1970's. Considering that "goodwill is a product of business", he analyzed the apparition and intensity of theories within their business environment[3].

A history of the mergers movements in the US is provided by Bump (1970), who showed the influence of institutional factors such as antitrust laws and tax pressures. Some historians have also made analyses about other countries, particularly the United Kingdom (Holgate, 1990, Nobes, 1992, Bryer, 1995), an important stream of which have based their interpretation of accounting change on the conflict between social actors' interests.

Social and Critical Viewpoints on Goodwill History

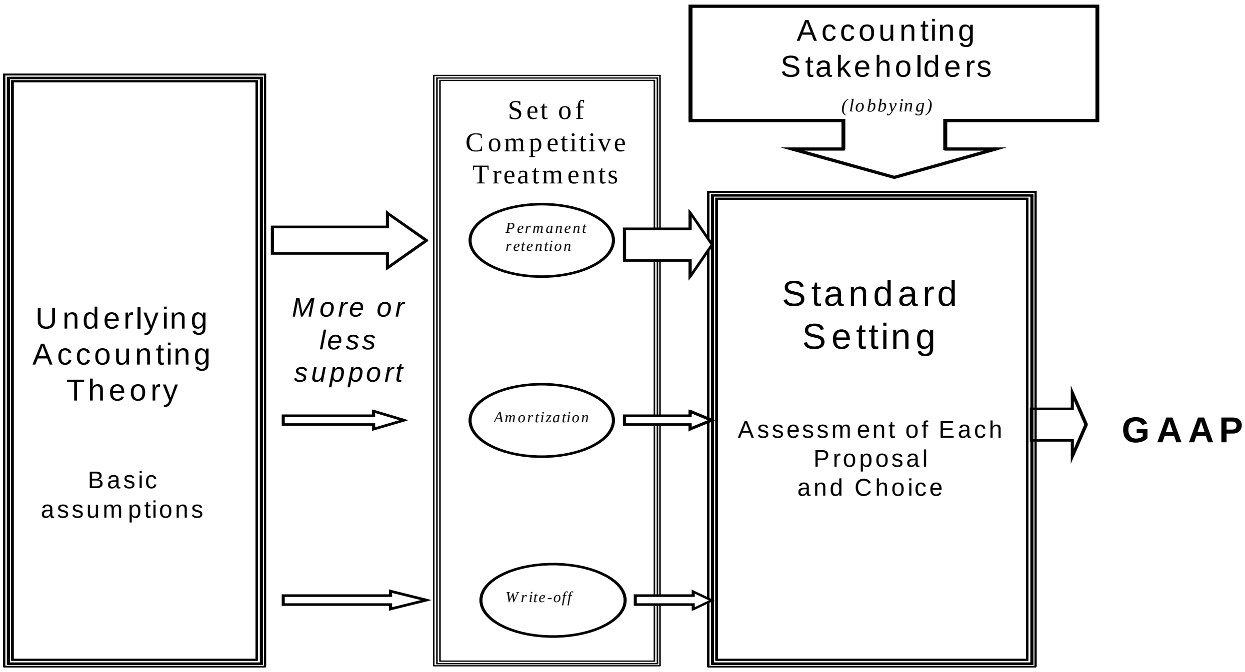
Nobes (1992) identified several parties involved in the political process of standard setting in the UK, and concluded that different pressures resulted in a "cyclical standard setting" of goodwill in the 1980's : on the one hand, "managers opposed standardization and income reduction, whereas senior policy makers, government, press and international influences proposed it".

Bryer (1995) also gave his interpretation of the same phenomena on the basis of a Marxist analysis. Accounting information is "necessary to allow the capital markets to observe the generation and realization of profit and the rate of return on capital." According to him, the British exception of SSAP 22 encouraging write-offs of goodwill "was in the collective interest of investors because it helped to hide from public view the fact that dividends were being paid from capital."

Ding et al.(2005) proposed a comparative history of accounting for goodwill in four countries : the US, the UK, Germany and France. Their analysis showed the competing influence of four social groups involved in accounting issues: investors, managers, creditors and the tax administration. Differences in corporate governance and the legal background of each country contribute to the explanation of diversity of goodwill's treatment.

[3] His work is largely referred to in the rest of this text.

2.2. Role of Underlying Assumptions in the Production of Standards



A large number of studies have investigated the influence of social actors in the standard setting process (right part of the scheme). In this paper, our interpretation is focused on the influence of underlying assumptions on alternative proposals.

Our hypothesis is that the theoretical support provided by accounting principles is a key element of the credibility of the alternative proposals. Their likeliness to be accepted does not only depend on the support of social actors in an institutionalized process, but also on their accordance with underlying theories investigated in this study.

2.3. Four Accounting Treatments and Two Underlying Assumptions

In the field of goodwill issues, acquired goodwill is probably the most representative because of its longevity. Debates about internally generated goodwill and other intangibles also reveal different views of accounting, but they are usually considered as the margin of a central, (purchased) goodwill issue. We propose therefore a simplified classification of accounting for purchased goodwill as a partial guide for our review in the next part.

Assumptions		To what information should accounting give priority?	
		Flows (~P/L)	Stocks (~B/S)
Does goodwill meet the definition of assets ?	Asset *(less conservative)*	**Valuation at cost** **Amortization over useful life**	**Market value** **No amortization**
	Not Asset *(more conservative)*	**Valuation at cost** **Immediate write-off against reserves**	**Liquidation value** **Rapid expensing**

P/L: income statement B/S: balance sheet

Two basic assumptions were used to distinguish the different treatments of goodwill. The first one is whether accounting should be primarily focused on the representation of flows - annual income - or the representation of a stock - net worth. From these basic views derive the two usual acceptations of goodwill we mentioned above: a composite cost or an excess earning power. The second one is whether goodwill meets or not the definition of an asset[4].

In short, this classification provides a framework to analyze the four alternatives usually mentioned in accounting literature (Ding et al., 2005):

Alternative 1: Recognition as an asset at cost, and amortization over useful life

Alternative 2: No recognition as an asset, or immediate write off against reserves

Alternative 3: Recognition as an asset and permanent retention in the balance sheet, possible adjustments of value (usually written down)

Alternative 4: Immediate or Rapid Expensing

[4] In other words, this assumption is derived from the question: what is an asset ?

3. Historical Review (1880-2001)

For the commodity of the study, we divided the period (1880-2001) into four phases according to the succession of regulatory bodies. The first period is the beginning of the goodwill issue in accounting (1880-1929), until the Great Depression. For this period only, we focused on economic circumstances rather than accounting standard-setting. The second period, after the Great Depression (1929-1959), shows the rise of historical cost paradigm through early AIA debates. In the following period (1959-1979), the debates switch from goodwill’s treatment to accounting for business combinations in the APB. In the last period (1978-2001), we show the partial replacement of the dominant theory of value and its consequences on goodwill’s standards provided by the FASB.

3.1. 1880-1929 Pre-regulatory Period

3.1.1. <u>Development of Goodwill in a Context of Economic Growth</u>

Rise of the Modern Corporate Form

In the late 19th century, economic growth in the United States engendered important changes in the business world. One such changes was a gradual separation of a firm’s ownership and management as a result of increases in corporation size. To facilitate the evolution, “no-par stock” laws were passed all over the United States, beginning with New York State in 1912 (Hughes, 1982, p 41). These laws increased the power of corporate boards of directors at the expense of owner and creditor-oriented institutions.

Effects of Economic Boom and Rising Prices

Continuing growth associated with a huge rise in price levels seriously disrupted the traditional conservatism with regard to valuation issues. In this context, the new corporate governance system exploited the absence of formal rules by developing questionable practices. Arbitrary write-up of assets or expense capitalization, for example, were a means to reappraise the balance sheet.

The Debut of Goodwill in Accounting

“The development of goodwill paralleled the development of business enterprise.” (Hughes, 1982 pp 18-19). As the form of businesses changed from individual enterprises to corporations, goodwill was no longer attached to its owner’s personality and became potentially transferable to other entities.

The recognition and valuation of goodwill also benefited from institutional change. “No Par-stock” laws required shares to be issued only after they were entirely paid for. In the case of a business combination, the payment consisted in the remittance of assets, which book value was generally inferior to the price of the shares issued. As a result, the difference was capitalized under the caption “goodwill”. At first, this practice was strongly criticized as a device of stock watering manipulations: “such an item is not merely immaterial, but also imaginary” (Hatfield, 1913).
Goodwill’s recognition was not taken for granted and a considerable amount of debates arose from the 1890’s.

3.1.2. **<u>Emergence of Two Major Streams</u>**

Recognition and Valuation of Goodwill

Historically, the conception of goodwill as an estimate standing for the excess earning power of the firm appeared first. According to Yang[5] (1927) “The normal amount of income generated by these assets is subtracted from the total income of the firm, and the residue is considered to be due to a complex variety of factors and is capitalized at some percent to determine an approximate value for goodwill.” In any case, no excess price is to be paid unless the company has a superior earning power.
On this matter, Freeman (1921) pointed out that factors necessary in the computation - the number of years and the rate of discount - were completely arbitrary and provided only a rough approximation.

Goodwill’s Scope

May (1961, p 90) notes that write-ups of goodwill were very frequent in practice, and that a diversity of questionable methods were used to put more goodwill on the books. As a consequence of this attempt to adjust book values to the market value of the firm, four potential sources of goodwill appeared in the balance sheet:

- Purchase of a going concern (acquired goodwill);
- Creation from extensive advertising (advertising expenses);
- Capitalization of early losses;
- Estimates written on the books (arbitrary write-ups).

[5] Yang (1927) is a book reprinted from his original doctor’s dissertation in 1907.

Naturally, the caption "goodwill" lost the confidence of information users due to the possible manipulations. Bankers were particularly reluctant and argued that intangibles "have been subject to manipulations of value to such a degree that they have become more or less a nuisance, and fail to possess any significance in the eyes of the ordinary reader" (Yang, 1927, p 184).

Immediate Write-off and Conservatism

One of the earliest authorities concerning goodwill was Dicksee, whose position remained very influential all over the 20th century. Considering that goodwill was a permanent asset just like land, he rejected the gradual amortization method. On the contrary, he recommended immediate write-off to capital, arguing that goodwill was "an asset which is undesirable to retain as such". If goodwill was written on the books, changes in the asset's value gave rise to an artificial exaggeration of the natural fluctuations of reported income. To avoid such technical embarrassment, Dicksee recommended that goodwill be charged to capital immediately (Dicksee and Tillyard, 1906).

In spite of the popularity of this view, its interdiction to corporations in Great Britain forced writers[6] to propose alternative treatments: "proponents of immediate write-off followed through as closely as possible with their same reasoning (modified by law […]) and decided that goodwill should be retained permanently as an asset in corporate accounts" (Hughes, 1982, p 32). A few years later, Montgomery (1913) also supported goodwill's permanent retention in the United States. The tax administration adopted in 1913 a similar position. Permanent retention was called for by tax law because of the unpredictability of the asset's duration. Besides, since goodwill was neither exhausted nor worn down as time passed, its amortization was rejected.

Gradual Reduction and Non-Permanence of Goodwill

Aside from the dominant conservative[7] stream, some writers defended the non-permanence of goodwill, and argued for a gradual and systematic amortization against earnings.

Hatfield (1913) argued that goodwill's permanence was inconsistent with valuation methods based on the capitalization of a *finite* series of excess earnings. A similar view can be found in Guthrie (1898), for whom no goodwill is eternal. Consistently with its finite duration, goodwill should be gradually reduced and charged against earnings. Later, this conservative approach was also defended by Paton and Stevenson (1922) and gradually came to its hour of glory because of the Great Depression.

[6]Even in the US, most of the literature concerning goodwill was of British origin until the 1910's.
[7] Note that British writers were much more conservative than American practitioners.

Comparing the two main streams, Hughes (1972, p 32) observed that: “The logic of either sets of arguments appears to have been consistent given the assumptions. Part of the problem was to be found not so much in the ultimate accounting practices advocated, therefore, as in the initial assumptions from which those accounting practices originated.”

3.1.3. Summary and Conclusions

During the period, accounting’s traditional role was disrupted by significant changes in corporate governance, rising price levels, and the needs of raising funds through a market in order to finance corporate growth.

In particular, the useful life of goodwill became a major accounting issue and a source of debate between two major schools of thought. While Dicksee and Montgomery assumed that goodwill was a permanent asset, Hatfield and Guthrie argued that everything passed and claimed for a gradual reduction. On the contrary, Dicksee favored immediate write-off because of valuation problems, and subsidiarily permanent retention in the balance sheet.

Conclusions Concerning the Criteria Proposed (Model p 6)

The basic distinction we proposed in the model was the emphasis given to the representation of *stock* (worth) or *flows* (income), which is very different from our findings.

There are no references, actually, to such argument in the literature reviewed, and the positions expressed are pragmatic rather than based on a consistent underlying framework. In the early developments, although references to “conservatism” are very frequent, this element constitutes no analytical criterion.

The inadequacy of the explanation is the probably due to its anachronism. An opposition between advocates of cost and those of net worth became apparent after the Depression, whereas the theoretical framework became apparent with the first regulation issues in the 1930’s.

3.2. 1929-1959 Early Regulations of the AIA

3.2.1. The Great Depression, World War II and Their Consequences

Creation of the SEC

In the 1930’s, the World was shaken by the Great Depression. Business revival was a long time coming after such a financial slump - resulting in social instability, political disorder, and eventually war.

As an attempt to restore the confidence in financial markets, several institutional reforms were implemented, such as the creation of the Securities Exchange Commission[8] (*Securities Exchange Act*, 1934) or the institutionalization of financial statements' audit for listed companies (*Securities Act*, 1933).

Major Events affecting Goodwill Accounting	
1929	Outbreak of the Great Depression
1933	Securities Act
1934	Securities Exchange Act (Creation of the SEC)
1944	ARB No. 24 "Accounting for Intangible Assets"
1950	ARB No. 40 "Business Combinations"
1953	ARB No. 43 "Restatement and Revision of Accounting Research Bulletins"
1957	ARB No. 48 "Business Combinations"

Development of Conservative Attitudes

In this context, accounting's reliability was seriously questioned: "The old rule which permitted, and in some cases encouraged, the recording of unrealized appreciation on the books of corporations, fell into disrepute because of the abuses that were committed in its name, and because of a change in the general concept of the major objective of accounting from the determination of net worth to the measurement of income and earning capacity." (ARB No. 40, 1950, pp 299-301).

Conservative attitudes also increased owing to the strengthening of the auditing system: an auditor's mission turned from fraud detection to the control of the "true value" assessed in the balance sheet (Montgomery, 1934, p 322).

A Paradigm Switch

The financial collapse revealed that there was no necessary relationship between the book value and the fair market value of the corporation (Hughes, 1982, p 76). As a result, the cost basis of fixed asset valuation soon became strongly established at the expense of market value[9], and the emphasis previously given to the calculation of net worth switched to that of income. As it was summarized by the AAA (1936), "accounting was not concerned with valuation, but with the allocation of historical costs and revenues to current and succeeding fiscal periods".

[8] One of the missions of the SEC was to establish accounting standards. In fact, this role was carried out by two professional bodies, the American Institute of Accountants (issuing ARBs) and the American Accounting Association. The AIA became American Institute of Certified Public Accountants in 1957, and created in 1959 the Accounting Principles Board.

[9] Market value was also accused of furthering the depression's propagation. When depreciation of financial assets appeared in a company's balance sheet, it worsened its own performance.

Huge consequences arose from this renewal of assumptions. In the case of goodwill, the cost principle merely forbade recognizing self generated goodwill and engendered a gradual switch towards amortization of purchased goodwill.

3.2.2. Conservatism and Reduction of Accounting Treatments

Goodwill and the Cost Principle

Among the four possible sources of goodwill previously mentioned - purchased goodwill, advertising expenses, early losses and arbitrary write-ups – three fell into disfavor after the Depression.

First of all, arbitrary write-ups came up against the “historical character of the balance sheet.” (Hughes, 1982, p80). A consequence of this principle was the omission of internally developed intangible assets: “It is generally admitted that a value should be placed on goodwill in the books only when goodwill has been purchased. The corollary is that goodwill should not be entered in the books of the business which builds it up” (Sanders et al., 1938, p 67). Furthermore, the cost principle was officially established in ARB No. 24 (1944), so that both arbitrary write-ups and capitalization of early losses were definitely excluded. Even though they may contribute to generate goodwill, extraordinary advertising expenditures should not be capitalized because of the uncertainty of their future effects and value (Walker, 1938, Paton and Littleton, 1940).

Fluctuations or Extinguishment of Goodwill

According to Avery (1942), financial statements in the 1930’s reveal a conservative trend towards writing-off, or writing-down goodwill to nominal values ($1). Yet, some supporters of permanent retention (Saliers & Holmes, 1937, p521) still advocate that “the market value of the goodwill has decreased, but there is no depreciation”; “it has simply failed to earn its anticipated amount of profit”. Goodwill does not depreciate but fluctuates, and should therefore remain at cost in the balance sheet (Montgomery, 1934, p312).

Preinreich (1937) raised the objection that liabilities could not be liquidated with capitalized expenses so that goodwill should necessarily be extinguished.

“Despite the adverse business conditions and criticism, the basic position remained intact. The return of more prosperous times as World War II approached could be used to illustrate that goodwill did fluctuate and therefore should remain at cost.” (Hughes, 1982, p 85).

The Matching Principle and Gradual Reduction

Though many authors conceded that goodwill's useful life was infinite, conservatism in business environment worked against its permanent retention. Goodwill should not be treated as an expense, but written off against earned surplus consistently with its assumed permanence (Montgomery, 1934, p 300). Like all arbitrary write-offs of assets, this treatment was soon considered unreliable due to its discretionary nature.

The other accounting treatment broadly supported by accounting writers of this period is gradual and systematic amortization of goodwill against income (ARB No. 24, 1944). Paton (1941, p 409) argues that goodwill is a "cost that is presumably expiring" and "assignable to future revenues". Therefore, the matching of costs and revenues through the income statement requires goodwill to be amortized. In addition to a strict adherence to the cost principle, this view has the advantage of its systematic nature, and gained an increasing support throughout the period.

Disfavor of Write-off

ARB No. 24 (1944) was the first official attempt to reduce goodwill's accounting treatments. After classifying intangible assets: "(a) type", those with a finite duration, and "(b) type", those with an indeterminate duration, ARB No. 24 proposes two possible treatments for goodwill. In the case it is assumed to be permanent (b type), it should be retained at cost. In the opposite cases (a type), it should be amortized against earnings. Write-offs are acceptable only when there is evidence that the asset has become worthless.

Further, ARB No. 43 (1953) "Restatement and Revision of Accounting Research Bulletins" and n°48 (1957) "Business Combinations" established criteria so restrictive that writing off goodwill became virtually impossible. The trend against write-off was confirmed by the SEC, which discouraged this practice in ASR No. 50 (1956).

References to the principle of matching costs with revenues played a decisive role in this evolution. As Walker (1953) or Emery (1951) argued, the allocation of goodwill to revenues generated from the acquired assets should be no different from the apportionment of the cost of any other asset to appropriate accounting periods.

3.2.3. Summary and Conclusions

Summary

After the Depression, accounting practices were seriously called into question. In addition to a general trend towards conservatism and a strengthening of accounting principles, exaggerations previously made in the goodwill account led to a distrust of goodwill appearing in the balance sheet (Sanders et al., 1938, pp 68-69). Goodwill was increasingly written off during the period. As

Hughes (1982, p 100) comments, "the practice of nominal valuation of goodwill might be viewed as part of the general trend toward conservatism then present".

ARB No. 24 (1944) adopted two possible treatments of goodwill: permanent retention if its duration is indeterminate, gradual amortization in opposite cases. Amortization advocates grounded their arguments in the historical cost and matching principles, which gave them a decisive advantage over those of permanent retention.

Conclusions

In this period, changes in the theories of goodwill are linked with those of general accounting views. The different schools of thought represented are close to the criteria we defined in the model p 6, excepted for the write-off advocates like Freeman (1921) or Montgomery (1934).

An interpretation of these views is as follows: the stream is basically a conservative version of permanent retention. Excepted for its origins, further analysis suggests classifying it in the 2nd alternative (of the model p 6). Immediate write-off, they advocate, allows removing goodwill from the balance sheet without any impact in the income statement. Whether priority is given to the calculation of income is unclear, but the protection of income's integrity is certainly an important motivation. In this regard, it can be considered an intermediary stage towards the income statement view.

3.3. 1959-1973 The APB Period

3.3.1. <u>Prosperity and Merger Movements</u>

"Pooling-of-Interests" Mergers

Continuous prosperity and monetary instability are some important economic features of the period. Despite inflation, arbitrary write-ups of assets met a strong opposition grounded in the cost principle which forbade the recognition of unrealized gains.

As Wyatt (1963) remarks : "considered in conjunction with rising price levels, a booming American economy, and a generally strong and rising stock market, the influence of the tax law becomes apparent. Potential vendors are far more inclined to sell their business for shares of stock than for cash, since the latter would result in an immediate tax liability."

These circumstances resulted in the spreading of a special type of mergers called "pooling-of-interests", first introduced in 1950 (ARB n°40).

Major Events Affecting Goodwill Accounting	
1959	Creation of the APB
1967	APB No. 9 “Reporting the Results of Operations”
1970	APB No. 16 “Business Combinations”
	APB No. 17 “Intangible Assets”
1973	The APB is replaced by the FASB

3.3.2. Write-off, Amortization and the Pooling-of-Interests

Origins of the Pooling-of-Interests Method

The practice existed from the 1920s, and became an important issue in accounting when write-offs were forbidden (ARB No. 43, 1953)[10].

Originally created to account for business combinations between companies of a similar size, its basic idea was that neither corporation had purchased the other, but two formerly independent entities were acting as one. Consequently, assets of both companies were to be “pooled” together and retained in the new entity’s balance sheet for their original book value. No purchased goodwill was to be recorded. Moreover, a pooling-of-interests combination was free of tax.

The “Pooling-Purchase” Debate

According to Wyatt (1963), the pooling-of-interests method was used as a means to avoid goodwill’s amortization. At first accepted by the SEC, the accounting treatment soon fell in disrepute: “ the effect is to nullify the accounting principles requiring substantially all charges to go through the income account. (…)Thus, pooling has had the unintended seeming effect of nullifying principles of conservative income accounting for which leading members of the accounting profession had waged a victorious battle” (Kripke, 1961[11]).

ARB No. 48 (1957) weakened the criteria distinguishing pooling-of-interests combinations from purchase ones, so that any combination involving a stock for stock exchange could be treated in either way. Several years later, APB opinion No. 9 (1967) forbade write-offs of goodwill to retained earnings. As a consequence, advocates of this practice changed their position into the defense of “non capitalization of goodwill in the first place”.

[10] Hughes (1982), p 121.
[11] in Hughes (1982).

Is Goodwill an Asset?

According to Spacek (1964), goodwill is not an asset, but “a cost to the buyer of earnings over and above the cost of the assets required to produce those earnings”; “Goodwill is not a resource or property right that is consumed or *utilized in the production of earnings*. Rather it is a result of earnings or of the expectations of them, as appraised by the investors.”
Catlett and Olson (1968) add that basing the valuation of goodwill on shares’ price represents nothing but the stock market’s speculation about the company’s future. As such a calculation is very volatile, goodwill’s amount should not be presented on the balance sheet.
Paton (1968) answers that “assets are not inherently tangible or physical. An asset is an economic quantum.(…) the distinction between tangibles, so-called, and intangibles, so-called, is not a fundamental line of cleavage. In principle, the intangible asset is just as admissible to the respectable, recognizable company of business property as something you can stub your toe on.”
Although critics of goodwill’s capitalization gained much support from practitioners, the historical cost approach was already strongly established and the subsequent views on goodwill remained dominant in the U.S. until 2001.

Should goodwill be expensed?

In addition to inferring that goodwill should not be treated as an asset, immediate write-off also implied that it was not expensed in the income statement (Hughes, 1982, p144).
According to Spacek (1964), amortization charges are wrong and potentially misleading since goodwill is not a producing asset: “the cost charged to the income account should represent the cost of producing earnings and not the cost of earning power.(…) It is the cost of the right to future earnings, but such earnings are not assured.” This argument was refuted on the basis that other fixed assets do not provide more assurance on future earnings.
The general position expressed by various writers favoring amortization of goodwill was that intangibles are like other assets and should be treated accordingly. “While the idea was by no means novel, it was advocated with increasing frequency and was subsequently embodied in Accounting Principles Board Opinion No. 17 in 1970.” (Hughes, 1982)

APB No. 16 (1970) “Business Combinations”

In 1969, the APB decided to suppress the pooling-of-interests method. Wyatt (1963) had already called for more restrictions of its use, but the difficulty of setting appropriate criteria to identify the two types of business combinations remained unsolved. The size criterion, originally 1/3, then 1/9, was finally abandoned in APB No. 16. “Opinion No. 16, curtailing but not abolishing the use of the pooling method, represented a compromise between the Board and its critics.” (Wyatt, 1963).

APB No. 17 (1970) “Intangible Assets”

According to APB No. 17, accounting for intangible assets should be consistent with the treatment of other long-lived assets: recorded at cost and gradually amortized. Since the useful life of goodwill is indeterminate, it must necessarily be set arbitrarily - in the limit of forty years. Amortization should be systematically charged to current income.

Both immediate write-off and permanent retention were de facto eliminated, which was a real departure from the current practice[12]. Opinion 17 was therefore criticized for its authoritativeness.

In particular, the arbitrary amortization period gave rise to much controversy. Defliese (1971, p 68) explains that amortization charges in addition to the natural expenditures to regenerate goodwill constitute a double charge on the same period. As the latter cannot be objectively differed, a long amortization period was set as a compromise.

After the APB was replaced by the FASB, a discussion memorandum about intangible assets of motor carriers was issued in 1976, but the project was finally abandoned in 1981 because of its “low priority” compared to other issues.

3.3.3. Summary and Conclusions

Summary

In this period, accounting treatments of goodwill were substantially reduced. Following immediate write-off in the 1950’s, permanent retention of goodwill was forbidden by APB No. 17 (1970), leaving gradual amortization as the unique treatment of purchased goodwill.

Although it was strongly supported by historical cost advocates, this authoritative evolution raised much opposition. Those supporting immediate write-offs and similar views contested the recognition of goodwill as an asset and its amortization against earnings. Capitalization of goodwill could be avoided through the use of the “pooling-of-interests” method consolidated in APB No. 16. Originally limited to rare cases, the method was extensively used over the period as a substitute for the (no more available) immediate write-off.

Conclusions

[12] When immediate write-offs were forbidden by ARB No. 43 (1953), companies could still avoid goodwill’s amortization due to the permanent retention method.

As the influence of the historical cost principle on goodwill accounting strengthens, our data correspond more closely to our model. This evidence suggests that the underlying theory reached a climax during this period.

Although permanent retention was frequently used in practice (Hughes, 1982, p153), it is almost absent from the debates: “Not only were no arguments advanced for it, virtually no one argued against it, so that it seems not to be considered a serious contender anymore.” The relative disfavor of this method is consistent with the general trend towards income emphasis. It is also noticeable that even if conservatism is frequently advocated, the recoverable value of goodwill is no longer questioned.

On the contrary, amortization found its support in the principle of matching costs and revenues. From the status of a preferred method, it became the only method of accounting for goodwill. Yet, opposition arose from the advocates of immediate write-off, non capitalization of goodwill and ultimately the pooling method as substitutes.

3.4. 1973-2001 FASB Conceptual Framework and its Consequences

3.4.1. Rise of Investors’ Viewpoint

Internationalization of Accounting Debates

Despite serious downturns in the 1970’s and 1980’s, the American economy was able to sustain the prosperous era begun after the second World War. Internationalization of capital markets allowed American companies to gain even more financing sources.

In this context, domestic accounting standards were challenged by foreign practices. A famous example concerning goodwill is the possibility offered to British companies to write it off immediately, whereas this treatment was forbidden in the United States.

Conceptual Framework

A major accounting innovation of the FASB in the 1980’s is the codification of a conceptual framework. Six SFACs were issued between 1978 and 1985, originally emphasizing a strict adherence to the historical cost principle, but the philosophy was significantly modified by SFAC No. 7 (2000) “Using Cash Flow Information and Present Value in Accounting Measurements”. This evolution has been described as a partial accounting paradigm switch from cost basis to fair value (Richard and Colette, 2005). More generally, the emphasis gradually moved from the representation of income's creation to a balance sheet approach.

Major Events in Accounting	
1978	Conceptual Framework: SFAC No. 1, followed by 4 other statements
1985	Conceptual Framework Achievement: SFAC n°6
2000	SFAC No. 7 "Using Cash Flow Information and Present value in Accounting Measurements"
2001	SFAS No. 141 "Business Combinations" SFAS No. 142 "Goodwill and Other Intangible Assets"

3.4.2. Separate Intangibles and Progressive switch to Fair Value

Goodwill and Alternative Assumptions

After the issuance of the conceptual framework, theoretical debates on goodwill focused on basic assumptions (historical cost or present/fair value) and much of the technical issues discussed in the previous period were pushed into the background.

According to Ma and Hopkins (1988), goodwill should be understood as the present value of "the future stream of superior earnings of the business" which cannot be accounted for properly under the historical cost approach. Yet, the contrast between internally generated and purchased goodwill in accounting could be resolved by switching to a value based assessment.

On the contrary, other writers (Grinyer et al.,1990, Grinyer and Russell,1992) defend the legitimacy of accounting for goodwill under the historical cost theory. In their views, assets "are resources waiting to be used up in the process of earning revenue, and whose cost will be matched as expenses against the revenue of the periods which they benefit[13]". Consequently, goodwill's present value represents a reservoir of future costs to be expensed later.

Goodwill was suspected of being inconsistent with the definition of assets provided in SFAC n°6 (1985, par. 26), which states that: "a particular entity can obtain the benefit and control others' access to it". According to Schuetze (1993), goodwill does not satisfy this criterion and should not be considered an asset.

[13] Grinyer and Russell (1992), quoting Barton (1977).

In response, Johnson and Petrone (1998), and Henning et al. (2000) argued that a “core” component of goodwill could be conceptually identified as an asset but that other components may not.

Recognition of Separate Intangibles

One consequence of the lack of consensus about goodwill was a shift in the debate regarding intangible assets (Tweedie and Blanchet, 1989). Unlike goodwill, which was defined under the cost assumption as an aggregate (Russell and al., 1989), separate intangible assets had a definite nature. Internally generated intangibles lacked theoretical support to be accounted for during the 20th century, but changes in the concept of value made them a possible alternative to goodwill at the end of the 1990’s.

Empirical Research and Goodwill

In the 1980’s and 1990’s, accounting research gradually focused on empirical applications of accounting information. Even if goodwill did not cease to be a matter of theory, arguments relied increasingly on positivist researches.

Two main fields were repeatedly investigated in the 1990’s, namely the “informative value” of intangibles, and the advantages provided by different methods of accounting for business combinations.

Concerning the perceived informative value of intangibles, a large number of studies (Lev and Sougiannis, 1996, Aboody and Lev, 1998, Lev and Zarowin, 1999, among others) provide evidence for a positive relation between intangibles and a company’s market value.

Moreover, the informative value of goodwill is significant for financial markets (Jennings et al., 1996); and the results provided by Chauvin and Hirschey (1994) show that some components of internally generated goodwill - advertising or R&D costs - also have an influence on a firm’s market value.

According to other studies (Moehrle et al., 2001), goodwill’s amortization charges have a low “value relevance” for investors. These results support the replacement of amortization by impairment tests, as finally adopted in SFAS No. 141.

Concerning shares’ price, Norris and Ayres (2000) show that financial markets react negatively to the use of the purchase method. Moreover, when the pooling method can be used (Robinson and Shane, 1991) the price offered for the target is significantly higher, a phenomenon called “pooling premium”.

In this regard, international comparisons (Choi and Lee, 1991) also revealed that merger premia were higher for combinations in which goodwill was not recognized. Moreover, Amir et al. (1993) show that reported incomes of US firms are lower than those of British ones because of immediate write-offs of goodwill.

Other evidence of a relative opportunism in accounting for business combinations is given by Aboody et al (2000) [14] who showed the influence of compensation plans and debt covenants. Ayers et al. (2000) also concluded that the pooling-of-interests method is perceived as a manipulation of financial statements and can be used opportunistically.

All these studies increased the questionings surrounding APB No. 16 and 17 so that advocates of a suppression of the pooling method and those of goodwill's amortization had a renewed support to their critics.

SFAS No. 141 and No. 142

The reform announced in 1996 by the FASB took five years to take shape in the final standards: SFAS No. 141 "Business combinations" and 142 "Goodwill and Other Intangible Assets".

A first project submitted in 1998 proposed to suppress the pooling method, and to use the purchase method in all business combinations. A second version was adopted in 1999 in spite of the resistance of the business community. In 2000, the project of replacing goodwill's amortization by impairment tests followed the changes introduced in SFAC n° 7 "Using Cash Flow Information and Present Value in Accounting Measurements".

A compromise between opponents of the pooling method and those of systematic amortization was reached in the final standards eventually issued in 2001. They stated that all business combinations should be accounted for under the purchase method and that goodwill should be permanently retained at cost, its present value being checked at least every year by an impairment test.

3.4.3. <u>Summary and Conclusions</u>

Summary

Permanent retention of goodwill was criticized under the cost assumption because it allowed the recognition of internally generated goodwill, but finally, it benefited from a growing disregard of alternative theories. On the one hand, misuses of the pooling method were criticized, and on the other hand, goodwill's amortization was criticized for being a burden on earnings and dividends.

[14] also Davis (1990), Nathan and Dunne (1991).

Only few authors expressed a positive support to the alternative since the 1940s, but the practice was very popular until its interdiction in 1970. The favorable context of SFAC No. 7 and a rise of the balance sheet approach completely revived the support to permanent retention.

Conclusions

Although it seemed that the controversy had finally been settled by the Accounting Principles Board Opinions 16 and 17, economic realities during the 1980s and the 1990s have rekindled discussions on goodwill.

During this period, arguments are increasingly based on the perception of information by financial markets, and no longer on analytical criteria. In a theoretical viewpoint, a partial replacement of the historical cost approach by present value permitted the return of the balance sheet approach. Consistently with this framework, the dominant position towards goodwill turned to permanent retention, as it was settled in SFAS No. 141 and 142.

4. Underlying Assumptions and Changes in Goodwill Accounting

4.1. Main Results

Cyclical Evolution of Assumptions and Treatments of Goodwill

In the preceding part, our review of accounting thought provides an illustration of the cyclic nature of theories' dominance in accounting.

At first (1880-1929), the well-matched couple of accounting for goodwill was a net worth-oriented paradigm and goodwill's permanent retention as an asset. The Great Depression, however, put an end to the balance sheet approach. Consequently, the historical cost paradigm gradually took the lead in accounting, providing precious support for goodwill's amortization. After World War II, prosperous economic context perpetuated the stability of the historical cost valuation and saw a constant promotion of amortization views.

Yet, advocates of this method encountered the resistance of those who worried about its consequences on reported income. In a theoretical viewpoint, serious doubts about goodwill's finite useful life or its earning capacity were raised.

Immediate write-off was the most serious alternative to amortization under the historical cost approach: since it prevented both goodwill's recognition and amortization, it was broadly used in practice. Soon forbidden in the 1950s, it was then replaced with the pooling-of-interests method in order to achieve similar goals.

In the 1980s and 1990s, the significant growth of financial markets involved increasingly targeting information at short term investors. Their increasing discontent about historical cost resulted in a move towards the concept of present value and the final adoption of permanent retention with impairment tests in SFAS No. 141 and 142 (2001).

Intensity of the Relations Observed

This review shows a strong relation between the dominant assumptions of a period and its accounting solutions for goodwill.

A first example is the common rise of the historical cost and amortization of goodwill in spite of severe reservations about goodwill's finite useful life. A second one is the shared revival of the balance sheet approach in SFAC No. 7 and the permanent retention of goodwill in SFAS No. 142 one year later.

On the contrary, the case of immediate write-off suggests a relatively weak reliance on accounting theory. Motivations underlying both the immediate write-off and the pooling-of-interests methods are more likely to be of a pragmatic nature, and theoretical concerns are relatively weak.

Period	Academic support and Economic context	Alternative Accounting Treatments of Goodwill				Dominant theory of value		Comments	Link between paradigm and solution
		Cost + Amortization	*Write-off or pooling*	*Permanent Retention*	*Rapid Expensing*	**Historical cost**	**Present Value**		
1880-1929	Intensity of writers' support	Weak	Strong	Strong	Weak	Weak	Strong	**Lack of references to underlying assumptions** Accounting principles are advocated but there is no consistent framework	-
	Evolution in accounting thought	Growing support	Dominant Position	Growing support	Decreasing support				
	Economic Context : prosperous era	-	unpropitious	favorable	unpropitious				
1929-1959	Intensity of writers' support	Strong	Strong	Weakened	Almost Absent	Emerging in the 1930's, then strong	Weak	**Rise of the HCA** in a context of strong conservatism Gradual reduction of possible alternatives in the literature	Model partly validated
	Evolution in accounting thought	Growing support	Growing support	Weakened support	Little support				
	Economic Context : Great Depression, then economic boom	favorable	favorable	unpropitious	favorable at the beginning				
1959-1973	Intensity of writers' support	Strong	Strong	Weakened	Almost Absent	Strong monopoly	Weak	Debates inside the framework of HCA Attempt to escape the consequences of amortization with the pooling method	Model validated
	Evolution in accounting thought	Growing support	Growing support	Weakened support	Almost none				
	Economic Context: prosperity, some downturns	favorable	favorable	-	-				
1973-2001	Intensity of writers' support	Strong	Weak	Strong	Almost Absent	Still Strong but Seriously questioned	Rekindled in the 1990's, then Strong	**Switch towards present value** Changes in the dominant treatment of goodwill are consistent with this change	Model validated
	Evolution in accounting thought	Weakened support	Weakened support	Growing support	Almost None				
	Economic Context: Growth of financial markets and Globalization	unpropitious	-	favorable	unpropitious				

4.2. Limits of the Study

Underlying assumptions towards accounting in general can explain many arguments found in the literature reviewed.

Yet, we observe that other concerns about the real nature of goodwill, technical problems of valuation, economic consequences of standards, and relevance for users also played an important role in goodwill's history.

Accounting for goodwill is a complex issue and we observed that all arguments advocated cannot be represented in a theoretical framework: some derive from technical problems, and others are merely the defense of vested interests.

5. Concluding Remarks

Our findings suggest that changes in goodwill accounting depend on the basic assumptions underlying accounting theories. Apart from the phenomenon of lobbying during the standard-setting process, collective accounting choices seem to be determined by a common vision of accounting acting as a shared base of communication.

Assumptions towards accounting evolve in time under the pressures of the business environment. These changes illuminate different avenues of possible accounting solutions. To this extent, accounting is doubly contingent: contingency of applications, but also contingency of the underlying theories.

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