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A Study on Goodwill and its Treatments in Accounting

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Abstract: The issue of goodwill being an intangible asset is controversial in accounting field in the world. Treatment of goodwill after recording it in the consolidated financial statements is very complicated so there are some techniques to avoid, alter and adjust it. That is why the issue of true and fair presentation of goodwill and its treatment is concern. Based on the desk review, this paper presents, discusses these issues and gives some comments its treatment in order to having a true and fair value of goodwill in the consolidated financial statements of reporting firms in the world and Vietnam as well.

Keywords: Goodwill, asset, treatment, accounting, IFRS.

I. Introduction

Goodwill is often regarded as the value attributed to such intangible assets (among others) as reputation, a well-trained workforce, good contacts within the industry, favourable business location, and any other unique features of a firm for which another firm would pay in excess of the value of net assets shown in the financial statements.

Much has been written on goodwill by eminent authorities, and so far as these writers have been able to determine, the subject of goodwill has not been adequately dealt with from an accounting perspective (Yang, 1927). Thus, goodwill has been the issue that is very controversial and seriously debated by academics and practitioners all over the world (Seetharaman *et al.*, 2004). It is commercially valuable and commonly considered as an intangible asset in the consolidated financial statements, and was defined by Hughes (1982) as the differential ability of a business, in comparison with others or an assumed average firm, to make a profit.

As early as 1929, Canning noted that the most striking feature of much of the writing on goodwill is the number and variety of disagreement on the nature of goodwill even though accountants, researchers, engineers and the courts have all tried to define it. Confusion and disagreements still exist (Falk & Gordon, 1977). Furthermore, goodwill is considered very hard to measure and even more difficult to account for (Sundararajan, 1995).

There has been little variation in the perspective taken by researchers approaching the issue of goodwill in the commercial and accounting fields, with goodwill having been described as the black sheep on the balance sheet (Carlin *et al.*, 2007) and as a will-o-the-wisp (Lee, 1971). Goodwill acquired in a business context is an asset with more prominence and material in the total assets because of a significant increase in the number of business combinations, especially in the context of global market development. So the issue of goodwill and a series of questions relating to its nature, its treatments and its disclosures in the consolidated financial statements are of interest to academics and practitioners.

Hughes (1982) traced the first known reference to the term 'goodwill' in a case that dealt with the transmission of an interest in a quarrying operation from one man to another. Meanwhile, Leake (1914) denoted the confusion surrounding goodwill as "never defined satisfactorily".

Goodwill, the most intangible of intangibles (Davis, 1992; Sundararajan, 1995) which can be immeasurable (Seetharaman *et al.*, 2006), has long been considered an important business asset in the literature. Recognising, measuring and disclosing goodwill in the consolidated financial statements has also been a controversial issue. Matters have been more complicated and confused by differences which have arisen between the legal definition of goodwill, mainly based on detailed cases, and accounting and economic models of goodwill which are seen to be broader in dimension.

The acceptance of goodwill as an intangible is still disputable in many studies for different reasons. Over time and across jurisdictions, a variety of practice in either avoiding goodwill recognition by using the pooling-of-interests accounting method or altering the magnitude of goodwill by using in-process research and development, has existed. A diversity of practice, to some extent, influences the reliability of financial information in the financial statements.

This paper sets out to cover some of the issues mentioned above. Specifically, section 2 provides evidence to show that goodwill is an asset. Section 3 presents techniques that avoid and alter the recognition of goodwill. Section 4 offers a way to measure purchased goodwill. Section 5 reveals some techniques for adjusting goodwill after initial recognition.

II. Is Goodwill an Asset?

2.1. Generally Accepted Definition of Assets

Assets or economic resources are the life-blood of both business and not-for-profit entities. The definition of assets in the professional literature is numerous (Carnegie, 1987) and has common agreements. According to paragraph 4.4 of *Conceptual Framework for Financial Reporting 2010* issued in October 2010 by HKICPA and paragraph 49 of *Framework for the Preparation and Presentation of Financial Statements* issued in July, 2004 by Australian Accounting Standard Board, an asset is a “resource controlled by the entity as a result of past transactions or events from which future economic benefits are expected to flow to the entity”.

There are three essential characteristics of assets, namely, future economic benefits, control by a particular entity, and occurrence of a past transaction or event. The first characteristic implies that an asset has the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the business in some way; for example, it can be exchanged, or it can be used to settle a liability or it can be used singly or in combination with other assets to produce products or services.

The second characteristic of assets reveals that the entity must have control over the future economic benefits so that the entity has the capacity to benefit from the asset. The entity that owns the asset is the one that can exchange it, use it for producing goods or services, exact a price for others’ use of it, use it to settle liabilities, or hold it. The third characteristic of assets denotes that transactions or other events giving rise to the entity’s control over future economic benefits must have taken place. Apparently, items become assets of the entity as the result of a transaction or an event or a circumstance that has already occurred.

2.2. Does Goodwill Match the Definition?

Even though goodwill has not been precisely defined, there seems to be general agreement on some of the characteristics of goodwill. Determining whether goodwill is an asset entails considering the nature of goodwill to ascertain whether it possesses the essential characteristics of an asset. Under the International Accounting Standards Committee’s definition issued in 1980, goodwill has some characteristics:

(i) Goodwill is indescribable and belongs to a business by its nature. Thus it cannot be separate from the business.

(ii) The value of goodwill can change significantly along with internal and external conditions of the business.

(iii) Goodwill amount and the approach employed for evaluating it vary for each firm.

As discussed in the previous section, the literature is replete with various opinions about the nature of goodwill. However, two main concepts include many of the assumptions underlying the divergent opinions, namely, goodwill represents Certain Intangible Resources and Excess Future Profits. Based on these two theories of goodwill, reconciliation between defined goodwill and the essential characteristics of assets is conducted for evaluating whether goodwill is an asset or not.

According to Certain Intangible Resources, there is an assumption that intangibles are contributing to the generation of a business’s overall profits. Goodwill therefore, representing the collective future benefits from intangibles, should be viewed as an asset (Carnegie, 1987). With regard to Future Excess Profits, the assumption is that the various intangibles involved represent future excess profits. As a result, goodwill should be considered as an asset on the premise that it will produce cash flows over and above normal expectations. However, if the business has not been making a return in excess of a normal return, there would be no goodwill and no related asset.

In order to ascertain whether goodwill satisfies the second characteristic of an asset, it is important to determine whether an entity can obtain the benefit from goodwill and control others' access to such benefits. The view of control pertaining to goodwill was advocated by Beresford & Moseley (1983, p. 21): "control of access to the goodwill is conducted by not divesting the acquired entity". This implies that the control criterion will be satisfied providing the resources of the business acquired are maintained (Carnegie, 1987). Therefore, goodwill acquired in a business combination, commonly named purchased goodwill, is not banned from being considered an asset. It is argued that "goodwill represents collective future benefits, with control of the access to these benefits being achieved so long as an entity's resources are not diverted" (Carnegie, 1987, p. 31).

To satisfy the third characteristic of an asset, it is necessary to establish whether goodwill existed as the result of past transactions or events. There is no particular problem involved if there has been some form of sale transaction arising from a business combination (Carnegie, 1987). This transaction is normally represented by a sale contract or other similar supporting documents. Goodwill would also be based on past transactions or events giving rise to internally generated goodwill.

As defined under the two major goodwill concepts, goodwill is not excluded from being regarded as an asset in accordance with the generally accepted definition of assets and the International Accounting Standards Committee's definition.

However, not all researchers in this field agree with the opinion that goodwill is an asset. Chambers (1966, p. 212) concluded that "goodwill is not an asset because it is neither severable, nor measurable, and consequently has no place on financial statements". Sands (1963, p. 183) also argued against considering goodwill as an asset, based on the fact that intangibles are not measurable. May (1975, p. 23) advocated this view by stating that "Goodwill attributable to the corporation as a whole can have no value to the corporation since it is not possible for the corporation to realize its value". Hendriksen (1982, p. 409) also argued that "… since goodwill is not a severable asset, it should not be reported separately".

These opinions notwithstanding, there is a huge volume of literature supporting the view that goodwill is an asset. Paton (1968, p. 143) stated that "assets are not inherently tangible or physical. An asset is an economic quantum … One of the common mistakes we all tend to make is that of attributing too much significance to the molecular conception of property." Gynther (1969, p. 255) concurred that "although these assets might be characterized by a lack physical substance, they often represent value in the form of future beneficial service potential and are no different, in an economic sense, from assets with physical substance".

Smith (1969) argued that goodwill is an investment and should be presented on the balance sheet. MacIntosh (1974) stated that goodwill is generally correctly accounted for as an asset because it represents an investment in a group of intangible assets and should be included among the total assets in an entity's balance sheet. Bloom (2007, p. 34) assumed that "the stream of future benefits" definition of an asset meshes well with the super-profit concept; with this mindset, goodwill does qualify for recognition as an asset, because it is aligned with a specific (through residual) flow of benefits".

The fact that goodwill cannot be sold separately from the rest of the business (i.e. goodwill sticks to the business as a whole), or measured easily, does not negate the fact that goodwill may have significant value to the business and therefore should be put in the consolidated financial statements (Falk & Gordon, 1977). As analysed above, goodwill satisfies the characteristics of an asset in the prevailing accounting practice, although there still exist some arguable issues relating to whether or not goodwill is an asset. It is therefore accepted that goodwill is not excluded from being defined as an asset.

III. Practice of Avoiding and Altering Goodwill Recognition

Goodwill arising from a business combination, and regarded as an asset in case the acquirer usually pays a higher price than the market value of the acquired firm's identifiable assets, such as equipment and inventories, net of any liabilities taken on (Sherman *et al*., 2003). That premium over the net fair value of identifiable assets is regarded as goodwill and is reflected on the acquirer's accounting books as an asset.

To further understand the nature of goodwill, it will be useful to examine the following example. Five hundred thousand dollars is paid for a firm with net identifiable assets, including current assets and non-current assets less any liabilities taken on, of $400,000. The premium, an amount of $100,000, is called goodwill and would be posted as an intangible asset on the consolidated balance sheet of the acquirer by writing a double entry as below:

Dr. Net identifiable assets	$400,000	
Dr. Goodwill		$100,000
Cr. Purchase consideration		$500,000

In principle, the value of goodwill recorded in the balance sheet of the acquirer is the value of the acquired firm's name, reputation and other intangible assets, such as intellectual property and work processes that, because of imperfect measurement, cannot be identified and measured separately. Goodwill also comprises elements relating to imperfections such as premiums or discounts arising from the process of negotiations (Carnegie, 1987).

In the example shown above, determining the fair value of identifiable assets seems to be more important than recording the value of goodwill because goodwill recognition that reflects on the acquirer's balance sheet is simple. In practice, there are a number of approaches that assist in avoiding the recognition of goodwill or altering the magnitude of goodwill. To some extent, either avoiding the recognition of goodwill or misstating the magnitude of goodwill would affect the reliability of financial information in the consolidated financial statements. Two methodologies have been adopted in the United States and widely discussed in the literature, namely, pooling-of-interests accounting, and in-process research and development.

3.1. Pooling-of-Interests Accounting – Avoidance of Goodwill Recognition

More than 30 years ago, considerable controversy focused on how firms accounted for mergers and acquisitions (Weber, 2004). The controversy emanated from the choice between the pooling-of-interests method and the purchase accounting method. Under the pooling-of-interests accounting method,[1] the balance sheets of each partner in the merger are simply added together, and the new firm reports a combined historical book value. As a result, there is no item of goodwill existing in the financial reports of the new firm.

Under the purchase accounting method, one firm must be the acquirer, and the other the acquiree. The acquired firm's identifiable assets are recorded at fair values and any excess of the purchase price is recorded as goodwill. The balance sheet of the combined firm is reported as the combination of the acquiring firm's book value and the acquired firm's fair value plus goodwill (Dunstan *et al.*, 1993; Sundararajan, 1995; Lewis, 2000).

The pooling-of-interests method was first employed in the United States in 1950 by the Committee on Accounting Procedure (Hughes, 1982) and prior to the release of the Accounting Principles Board (APB) Opinion No. 16 – *Accounting for Business Combinations*, and APB Opinion No. 17 – *Intangible Assets* in 1970. There was no regulation requiring the choice between pooling-of-interests accounting and purchase accounting in the United States. In practice, pooling-of-interests accounting was the generally accepted method (Lewis, 2000).

Pooling-of-interests was common among firms because no goodwill was recognised, and as a result, there was no goodwill to amortise in post-merger accounting periods (Sherman *et al.*, 2003). The Financial Accounting Standards Board (FASB) suggested that firms were willing to incur costs associated with the use of the pooling-of-interests method because share prices are favourably influenced by the application of the pooling method (FASB, 1997, p. 24).

In June 2001, the FASB voted to eliminate pooling-of-interests as an acceptable method of accounting for business combinations and issued the Statement of Financial Accounting Standards (SFAS) No. 142 – *Goodwill and Other Intangible Assets*. Under SFAS No. 142,[2] United States firms are required to capitalise goodwill and amortise it, applying a straight-line basis for a period of not more than 40 years (Johnson & Petrone, 1998).[3]

The amount of goodwill amortisation is recorded as an expense, and consequently this reduces earnings. For this reason, firms had a tendency to apply the pooling-of-interests method that produces no goodwill value and has no impact on profits, rather than employ the purchase method that produces goodwill and influences profits (Johnson & Petrone,

[1] Pooling-of-interests accounting is also called 'merger accounting' (Sherman *et al.*, 2003).

[2] Accounting Principles Board (APB) Opinion No. 17 'Intangible Assets'. According to APB No. 17, immediate elimination of goodwill was prohibited, as was the recognition of internally generated goodwill.

[3] The majority of United States companies amortize goodwill over the maximum allowable useful life of 40 years (Duvall *et al.*, 1992).

1998; Weber, 2004). As a result, firms employing the pooling-of-interests method produced higher reported earnings than firms using the purchase method. Hence the reason many United States firms kept goodwill off their balance sheets (Sherman *et al*., 2003, p. 93).

The generally accepted principle in a business combination was that the purchase method was employed to account for goodwill if the business combination was not in a merger, otherwise the pooling method would be used. Many firms doing business in the United States admitted that the business combination in question was a true merger of equals rather than the acquisition of one firm by another firm to take advantage of employing the pooling method.

The United States firms tried to design purchase consideration to satisfy the requirements of the pooling method. Purchase consideration, generally, should be all equity (i.e. no cash consideration), otherwise it could be deduced that the firm paying cash must be buying the other, which would make the deal an acquisition, not a merger.

Few business combinations are genuine mergers of equals, and acquisition is apparently not a merger; but if the business transaction is structured in the right way it can be regarded as pooling-of-interest (Sherman *et al*., 2003). Dr. Lewis, president and chief executive officer of Prospect Technologies Company, did not agree to prohibiting the use of the pooling-of-interest method of accounting. He stated: "… the result of the merger created a synergy that allowed us to bid and win contracts that would not have been possible by either of the two previous firms individually" (Lewis, 2000, p. 5). Spacek (1964) supported neither the capitalisation and amortisation of goodwill nor the pooling-of-interest method.

The basic hypothesis is that a business combination is regarded as an opportunistic activity for maximising post-acquisition profit. By choosing the pooling-of-interest method, firms can control earnings management.

There is evidence that business combinations were structured in a manner that satisfied the requirements of the pooling-of-interest method (Watts, 2003) and acquirers offered greater purchase consideration to obtain cooperation with the target firm to extract the benefit of the pooling method (Nathan, 1988). It has also been found that firms were more likely to employ the pooling method where fair values substantially exceeded book values and more likely to adopt the purchase method where the carrying amounts closely matched market values (Copeland & Wojdak, 1969).

Another technique that affects recording the value of goodwill is In-Process Research and Development (IPRD). This technique, which relates to the classification of the premium over IPRD, rather than classifying the premium, will be debated in the next section.

3.2. In-Process Research and Development – Altering the Recorded Value of Goodwill

The IPRD phenomenon came to public attention in the mid 1990s, when many firms announced corporate acquisitions, in which incomplete research and development projects constituted the major asset acquired (Deng & Lev, 2006).

According to Deng & Lev (2006), IBM's acquisition of the Lotus Development Corporation in July 1995 was among the first of the large cases in which IPRD played a prominent role. The total acquisition paid for Lotus Development Corporation was $3,200 million. Under the purchase accounting method, IBM calculated the fair value of Lotus's tangible net assets (mainly cash, accounts receivables, land and buildings, equipment) at $305 million, and the fair value of identifiable intangible assets (trademarks, assembled workforce and leasehold improvements) at $542 million. Current software products were estimated at $290 million. Deferred tax liabilities were valued at $305 million. IBM also estimated the value of Lotus's IPRD, new products and services in the research and development process, at $1,840 million, making up almost 60% of the acquisition price. So, goodwill that represented the difference between the acquisition price and the total fair value of net assets amounted to $564 million. Goodwill as an asset was reflected in the consolidated financial statements.

During that period, it was common for IPRD to account for from 60% to 80% of the total acquisition price (Annon, 1999; Sherman *et al*., 2003). It is a fact that the higher the percentage of IPRD, the less the percentage of goodwill in the total acquisition price. Apparently, by taking advantage of opportunistic behaviour in valuing IPRD, the magnitude of goodwill is misstated.

As shown in the prominent instance above, IPRD is defined as the value allocated to R&D projects in acquisitions reported under the purchase method, and described as an intangible asset that is included in the acquisition price (Dowdell & Press, 2004).

According to the provisions in APB Opinion No. 16 – *Business Combinations*[4] in accounting for business combinations under the purchase method, acquiring firms should apportion the acquisition price among tangible and intangible assets, based on the fair value of assets. Moreover, under paragraph 5 of the FASB Interpretation No. 4,[5] costs assigned to assets to be used in a particular R&D project that do not have an alternative future use "shall be charged to expenses at the date of consummation of the combination". This provision is consistent with the general treatment of R&D in the FASB Statement No. 2 – *Accounting for Research and Development Costs*, which was issued in 1974.

In the process of a business combination, the acquiring firm makes judgments in allocating the purchase price to a series of assets including tangible and intangible assets. Regarding the value of intangible assets, the acquiring firm also decides which parts or purchased intangible assets do not have alternative future use (Dowdell & Press, 2004). So the value of the assets allocated to R&D projects that seem to have no alternative future use is regarded as IPRD, treated as an expense and charged immediately upon consummation of the acquisition.

The difference between IPRD and goodwill in the purchase method is that IPRD is required to be expensed and charged immediately against earnings, whereas goodwill is required to be capitalised and amortised over future periods (Dowdell & Press, 2004; Deng & Lev, 2006). By classifying rather relatively and subjectively, there is a high possibility that an acquiring firm misstates IPRD; IPRD is usually overstated rather than understated. This affects the value of goodwill recorded in the consolidated financial reports.

Deng & Lev (2006) argued that the immediate expensing of IPRD significantly reduces the asset and equity bases of the acquiring firm, thus inflating widely used profitability measures, such as return on assets or return on equity. Management would prefer recording expense at once and starting the firm off with a clean slate, to treating R&D as an intangible asset that will affect profits until it is completely amortised (Sherman *et al.*, 2003).

Hence many firms adopt opportunistic behaviour in allocating acquisition price to IPRD for the sake of earnings management. In responding to earnings management and public criticism, the FASB stated that firms would be required to expense the amount of IPRD against future periods, rather than expense it immediately at the time of acquisition. However, in July 1999, the FASB stated that the amount of IPRD applied against future periods should be deferred and the issue further investigated (Dowdell & Press, 2004).

The FASB also intended to issue an exposure draft that would capitalise IPRD and then impair it periodically. A final standard pertaining to recognising and treating IPRD was expected in 2005 (Deng & Lev, 2006). In January 2009 the FASB announced that the project in relation to IPRD treatment was removed. Consequently, a standard of IPRD never became a reality. Nowadays, the topic of accounting for IPRD remains controversial and is still fertile ground for mischief in accounting treatments (Sherman *et al.*, 2003).

By restructuring the merger permits United States firms to apply the pooling-of-interest accounting method for avoiding value of goodwill. Allocating the acquisition price to IPRD based on subjective assumptions resulted in writing it off immediately upon the date of acquisition. This indicates that United States firms may have had motives for avoiding goodwill recognition or altering the magnitude of goodwill.

While pooling-of-interests and IPRD did not exist in Hong Kong, there is the question of whether or not Hong Kong firms employed a means of avoiding goodwill recognition or altering the magnitude of goodwill value.

There would have been some inconsistencies and problems in practice bearing on initial goodwill recognition in the balance sheet of an entity. The next issue pertaining to goodwill focuses on subsequent treatments of goodwill.

IV. Measurement of Purchased Goodwill

Under the purchase method of accounting for business combinations, goodwill value is the excess of the cost of acquisition over the fair value of identifiable net assets (Seetharaman *et al*, 2004). So, in order to measure the amount of goodwill to be recorded as an asset, determining the cost of acquisition and fair value of identifiable net assets is necessary.

[4] APB Opinion No. 16 – *Business Combinations* was promulgated by the American Institute of Certified Public Accountants in 1970.

[5] FASB Interpretation No. 4 – *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method – An Interpretation of FASB Statement No. 2*, was promulgated in February 1975.

At the date of acquisition, the fair value[6] of the acquisition cost should be ascertained. The cost of acquisition may consist of cash in capital and may also consist of non-monetary considerations such as shares issued and liabilities taken on. In instances where shares are issued as part of the purchase consideration, the value attributed to these shares may be very difficult to determine, especially where the shares are not listed in the securities market. Even where the shares are listed, their values may be uncertain if the share prices have been volatile or are temporarily affected by the activity associated with a business combination (Carnegie, 1987). In the content of paragraph 53 of IFRS 3 – *Business Combinations*, acquisition-related costs are generally recognized as expenses.

Having determined the cost of acquisition, the cost is assigned to the underlying net assets (i.e. the identifiable assets and liabilities acquired) on the basis of their fair values at the date of acquisition. Goodwill, which is the excess of the cost of acquisition over the fair value of identifiable net assets, will then be recorded as an asset in non-current assets in the acquiring consolidated balance sheet. The issue of adjustments of goodwill after recognition will be discussed in the next section.

V. Goodwill Adjustment Subsequent to Recognition

The appropriate adjustment for goodwill subsequent to acquisition has been debated for many years. One view was in favour of writing goodwill off at once against the reserve account in line with the prudence principle. The second view was to keep goodwill permanently with no full elimination or amortisation unless a permanent diminution in value was evident. The other view was to amortise goodwill over the useful economic life in line with the matching principle (Seetharaman *et al.*, 2004).

It is not uncommon practice to adjust goodwill after it has been recorded in the account. Over time and across a range of jurisdictions, a tangled web of different goodwill adjustments subsequent to recognition has occurred. There are three major types of adjustments, namely, lump sum write-off, ad-hoc write-off and systematic (periodic) write-off (Carnegie, 1987).

5.1. Lump Sum Write-Off

According to this approach, the amount of goodwill acquired in a business combination is eliminated immediately against reserves in the balance sheet or written off to the income statement in the year of acquisition (Elliott & Elliott, 2006).

Capitalisation and amortisation are arbitrary and highly likely to make net income understated (Spacek, 1964); therefore, a better treatment is to eliminate goodwill immediately against retained earnings. Another argument for immediate write-off is that it is reasonable to expect the goodwill relating to the firm at the time of purchase will eventually disappear over time (Seetharaman *et al.*, 2004). Yet another reason is that the write-off achieves the best matching of benefits with the costs incurred (Carnegie, 1987).

Supporters of this school argue that goodwill poses measurable difficulties and is different from other assets, that is, goodwill cannot be sold separately in most cases. In these situations, carrying the intangible asset in the consolidated balance sheet is of little value to users of financial statements (Seetharaman *et al.*, 2004).

5.2. Ad-Hoc Write-Off

An ad-hoc write-off initially capitalises goodwill acquired in a business combination as an intangible, at cost, without amortisation unless a permanent diminution in value becomes evident (Carnegie, 1987). In the case of apparent permanent diminution goodwill is usually reviewed periodically, and a write-off equivalent to impairment in value is reflected in the consolidated financial statements.

In support of this approach, Ballie (1976) and Leo & Hoggett (1984) argued that goodwill itself does not reduce in value because it is continually maintained or replenished through the normal business operation. If there is any indication that goodwill is not being maintained or replenished, then the original investment in goodwill will be reduced by an appropriate amount that is determined by management (Carnegie, 1987).

This school was opposed by other researchers such as Most (1977) and Emanuel (1973) because it confuses or combines internally generated goodwill subsequent to an acquisition with that purchased at the date of acquisition. As a result, it

[6] Fair value is a market value method for measuring cost and reflects the value an asset could be exchanged for in an arm’s length transaction between knowledgeable and willing parties.

provides for the recognition of internally generated goodwill in the consolidated balance sheet.

5.3. Systematic Write-Off

When goodwill value is initially capitalised and recorded as an asset in the consolidated financial statements, at cost, a systematic write-off of goodwill[7] should be employed over a finite term. A periodic write-off of goodwill acquired in a business combination involves a policy of amortisation over a reasonable period of time. Early support for this school included Guthrie (1898) and Hatfield (1909).

According to Seetharaman *et al.* (2004), there are three reasons for supporting systematic amortisation. The first is based on the premise of the matching principle (Leake, 1930; Paton, 1941) where the cost of purchased goodwill should be amortised as a means of matching the cost of securing the income actually obtained. The second is that under stewardship accounting, management should be asked to justify acquisition of other firms by proving that cash inflows from a business combination exceed the cash outflows incurred when the investment was made. The final reason involves the Momentum Theory of Goodwill (Nelson, 1953), that the purchaser of a firm normally pays a large sum of money for the goodwill because he/she wants a starting push in the new firm, rather than starting fresh in a similar firm and devoting so much effort and money over a long period of time to develop such goodwill (Seetharaman *et al.*, 2004).

In calculating the amount of the systematic amortisation of goodwill, determining an arbitrary useful life for goodwill acquired is necessary. However, it is very difficult to ascertain the accuracy of useful goodwill life. So this creates the prospect of a mismatch between income and expenses. According to Baillie (1976), any mismatching may be unlikely to be material and in any event, would be less material than failing to consider the diminution in the value of purchased goodwill.

According to Morrissey (1966), a systematic policy of goodwill is consistent with the treatment of depreciable assets which have finite useful lives. However, it is contentious that the selection of an arbitrary period is consistent with the notion that goodwill eventually disappears (Carnegie, 1987).

In short, the issue of accepting goodwill as an asset has been a debatable issue for a long time. However, based on the characteristics of goodwill and compared with the characteristics of assets, goodwill is viewed as the most intangible of intangibles (Davis, 1992) and recorded in the consolidated financial statements.

There have been controversies pertaining to the improper use of the pooling-of-interests accounting method for avoiding goodwill recognition and profit impact, excessive or deficient IPRD for altering the magnitude of goodwill, immediate post-acquisition write-offs and the use of aggressive expense deferral amortisation techniques (Carnegie, 1987; Carlin *et al.*, 2007b). To some extent, all affect the reliability of financial information in the statements of reporting entities.

From 1 January 2005, goodwill treatment has been conducted according to the new method of impairment testing. It is interesting to recognise that the rejection of the traditional 'capitalise and amortise' method in treating goodwill after acquisition is not new. The shift from the traditional method of 'capitalise and amortise' to the IFRS 'capitalise and test for impairment annually' is not inherently new, as evidenced in a growing body of literature dealing with both the conceptual foundations and practical consequences of the IFRS and US GAAP impairment testing method.

With regard to new method of 'capitalise goodwill and test it for impairment', there is a lack of evidence showing that earnings figures under the new regime are more relevant than those generated under the traditional regime of 'capitalise and amortise' (Chen *et al.*, 2006). There is also not enough evidence of undue delays in recognising impairment charges (Ramanna & Watts, 2007) and evidence of gaming in the way in which goodwill is allocated between cash generating units for minimising the chance of forced impairment charges (Zhang & Zhang, 2007).

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