The Season Of Goodwill...for FASB

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I'm delighted that FASB want to improve the accounting and reporting of goodwill in 2021, as per this article in the [Wall Street Journal](). This is something that has needed to be addressed for a long time. There are lots of interesting thoughts and opinions on the subject, and here is my take on a couple of them.

Let's get clear on what goodwill is first. It represents the surplus that one company pays to buy another company, over and above the value of the net assets it actually acquires as a result. This often happens, since market value and book value are two inherently different things. And it matters because some of these numbers involved here are mind-bogglingly big. In 2017 alone, $319bn of goodwill was added to US companies Balance Sheets, according to Duff & Phelps. Or over a trillion dollars from 2013 to 2017. And $79bn of it was written of [in 2018.]()

Currently goodwill is assumed to have an 'indefinite' life. This means that the value of the goodwill created on acquisition sits on the Balance Sheet of the acquirer, until such time as it is deemed to have lost value, at which point in time there will be an impairment (also called a write down or write off) of the asset. This results in a large one-off expense being recorded, which in turn hits the profits of the acquirer in their Income Statement. Critically, the goodwill may not be deemed to lose value, so it can stay on the Balance Sheet seemingly forever.

FASB is suggesting reverting to regular amortization (or amortisation, for the rest of us) of goodwill using a straight line model - and I am fully supportive of and in favour of such a change. What this accounting would mean, is that the goodwill asset would be given a finite life, say 10 years as mentioned by WSJ, and the asset would be gradually reduced in value over that time. This means it would be gradually expensed over time and reflected in the profits of the acquirer over a known time scale (profits can also be called earnings or net income....depending on your preferred accounting language convention....).

So, why do I think this is important? Well, under the current treatment, when you pay a large sum to acquire another company, that cost is capitalised and captured on the Balance Sheet and stays there UNTIL THINGS GO WRONG. Essentially the cost of acquiring the company is simply NOT accounted for through the Income Statement at all until that point in time, if ever. This strikes me as fundamentally wrong : you buy a company, you add their profits to your bottom line, but the amount you paid out to buy that company DOES NOT come off your bottom line. The acquisition appears to be 'free'. This makes no sense to me. Accruals accounting is all about attempting to allocate gains and costs to relevant accounting periods. Recognising the profits from the acquisition over time, but not the costs associated with the acquisition, breaks this fundamental philosophy.

Having taught literally thousands of people about accounting, in Colour Accounting workshops and seminars all over the world, I know from experience that a lot people out there (excluding accountants that is) aren't really sure what goodwill is in the first place, let alone what impairment or amortisation is. This means that a lot of people are unaware, through no fault of their own of course, of how or why these huge costs can suddenly appear out of nowhere, and grab the headlines when they do.

When companies do finally write off or impair goodwill, and it makes those headlines, they explain it away by classifying it as 'exceptional' and dismissing it as 'non-cash'. Both of these positions are entirely disingenuous and misleading. There is nothing 'exceptional' about it, as these situations are not rare or unexpected. Companies buy other companies all the time - 36% of public companies have goodwill on their Balance Sheet, and 10% of those recorded impairment in 2017 alone, according to Duff and Phelps. While according to this PwC report, only

61% of acquisitions create value, which means that 39% do not. And when CEO's say 'non-cash', what they actually mean is 'not cash now'. It WAS cash, because the company did pay that amount out in cash. It's only the accounting rules that mean't you didn't have to recognise that cost previously and you have to take the hit now that the mistake has been found out.

So, let me address the two arguments in the article that are against the change:

1) Companies don't like regular amortisation because it dilutes their earnings. Well, companies don't like anything that dilutes their earnings numbers, that's not the issue. The issue is whether or not it SHOULD hit profits, and as I've argued above, I believe it should. At the moment companies have their cake and eat it - make an acquisition, include the profits going forwards, yet ignore the cost of acquisition. The truth is this - the current regulations mean their earnings are inflated. The change won't falsely dilute their earnings, it will rightly reduce them to a lower and more realistic level by accounting for the surplus cost of the acquisition over time, against the earnings from that acquisition. In exactly the same way we currently treat non-current tangible assets (via depreciation) and non-current intangible assets (via amortisation). It is the current situation that is anomalous.

2) Some investors, analysts and academics are against it because “Amortization is a very arbitrary annual number to put on the financial statements”. Well, yes it is, but since when have arbitrary numbers been a problem?

Firstly, there are already lots of arbitrary numbers in financial statements, and we accept all of those readily, so it is not a problem to have arbitrary numbers. Besides, keeping goodwill as an indefinite life asset is also, by definition, arbitrary. The question therefore is actually about <u>which</u> arbitrary number would you rather have? There is a choice between trying to get an asset value right, or the profit value right, and personally, I'd go for profit every time. And since we never revalue goodwill upwards, any argument in favour of getting the asset value right is inherently flawed from the start.

Secondly, including ANY number for amortisation is, in my opinion, infinitely better than including NO number at all for it, even if the number is indeed judgemental. As long as people understand what it is, why it is there, and how it is being accounted for, amortising it is far better than the current situation of not amortising it, which means acquisitions appear to be 'free' from an Income Statement perspective.

And thirdly, the issue can (and is) neatly side-stepped anyway by companies talking about their EBITDA. Companies now do this regularly (rightly or wrongly - don't get me started on EBITDA....) and this therefore affords everyone an easily accessible metric of profit that hasn't been 'diluted' by the 'arbitrary' amortisation. In short, this means both objections actually already have a ready-made solution. They are not valid issues.

I'll be very interested to see how this pans out and what the final changes are, especially as the IASB also has a discussion paper that also proposes the amortisation of goodwill. It would make perfect sense for both of these to be implemented, and done so consistently. Now that really would be working to simplify things and provide consistency for all users of accounts.

Accounting should be simple and accessible to all, not smoke and mirrors. And that's why I'm so glad to be a part of the Colour Accounting movement - representing accounting visually in a way that makes it easy to learn and easy to understand. As everyone who comes on a Colour Accounting course knows, we get rid of the smoke and we show you where the mirror are, so that suddenly accounting becomes crystal clear.

If you want to boost your own financial literacy, and understand accounting properly so that you can understand business better, look no further than your local Colour Accounting expert.