The business world of the 20th and 21st centuries is one that has become more and more susceptible to mergers and acquisitions. As a result of the industrial revolution, and the more recent technological revolution, some firms were, and continue to be, able to gain the competitive advantage over competitors, leading to their acquisition (Hughes 16). With the increase of business acquisitions, there was a need to reexamine old accounting principles in order for the transactions to be properly recorded; this accounting is known as goodwill accounting. The concept of goodwill accounting has surprisingly been present for over a hundred years, first appearing around the 1880’s (1). Since its creation however, goodwill accounting has been a source of debate and controversy due to its adverse effects on the net income of numerous firms. Goodwill accounting has undergone recent revision by the FASB, specifically in the area of goodwill impairment. The purpose of this paper is to examine the history of goodwill accounting, the initial amortization method and revised current method of testing for impairment, and the needed, yet sometimes detrimental effects this accounting has had on several high-tech industrial firms. Without proper accounting for goodwill impairment, several firms would have the ability to overstate their net earnings and destroy the reliability of the financial statements in the eyes of investors.
To understand the history and need for goodwill accounting and impairment, one must start with a definition of the concept. According to the Intermediate Accounting text by Stice, “goodwill is best thought of as a residual amount, the amount of the purchase prices of a business that is left over after all other tangible and intangible assets have been identified (Stice 577).” This definition dictates that goodwill is another intangible asset that accounts for the business working as a whole compared to the individual components. Another definition of goodwill as provided by Hugh Hughes states that, “goodwill may be thought of as the differential ability of one business, in comparison with another or an assumed average firm, to make a profit (Hughes 7).” These definitions are, in short, describing the presence of a synergy that a business possesses which allows it to earn more extensive profits compared to another.

The need for revised accounting for acquisitions and business combinations arose in 1970 in response to an outbreak of acquisitions during the 60’s (Davis). Initially, there were two methods for this accounting known as the pooling of interest method and the purchase method. The first of these basically combined the ledgers of the two companies. The latter method required all assets to be recorded on the books at their fair values as of the acquisition date. This purchase method often inflated some of the assets because fair value was often greater than book value; this discrepancy led to inflated depreciation and amortization charges which reduced a company’s retained earnings. In 2001, Statement No. 141 was issued by the FASB, eliminating the use of the pooling method. This was only able to pass because the FASB worked to compromise with businesses on the amortization issues with goodwill; the resulting compromise came to be known as goodwill impairment (Stice 577).
The U.S. GAAP guidelines for goodwill impairment are laid out in FASB Statement No. 144, which was also issued in 2001. This statement answers four important questions in relation to goodwill impairment testing: when an asset should be reviewed for possible impairment; what qualifies as impaired for an asset; how should the impairment loss be measured; and what information should be disclosed about the impairment. To answer the first question, “companies are required to conduct impairment tests whenever there has been a material change in the way an asset is used or in the business environment...[or] if management obtains information suggesting that the market value of an asset has declined, an impairment review should be conducted (Stice 633).” As will be discussed later, this guideline has caused a lot of trouble for companies during the recession. For the second question, an asset is impaired when the undiscounted sum of estimated future cash flows from that asset are less than the recorded book value; this is known as the two-step test. For the third question, the impairment loss is the difference between the book value and the fair value of the asset which is calculated through a present value computation of the estimated future cash flows. In answering the last question, an impairment loss should be recorded as part of income from continuing operations. The disclosure in the notes should describe the impaired asset, a reason for the impairment, a description of the measurement assumptions and finally the business segment affected (633). It is also important to point out that under GAAP, once the asset is impaired, the impairment cannot be reversed (654).

After discussing the U.S. GAAP standing on goodwill impairment, it is very important to also examine the international standards being released by the IASB, as the United States may soon be switching to IFRS. In regards to goodwill impairment the IASB released IAS 36 in 1998,
which was revised in 2004; this standard lays out a one-step test for impairment in which if the recorded amount of the asset is less than then recoverable amount, write the asset down to its recoverable amount. The recoverable amount of an asset is defined as the greater of either the selling price of the asset or the discounted future cash flows. Many view the international standard as more conceptually superior than the FASB standard because it avoids using the unappealing undiscounted cash flow amount. Another important difference of the IASB standard is that the impairment does have the chance of being reversed if events in subsequent years provide a situation in which the asset proves to be no longer impaired (635). This standard, if implemented in the United States, could tremendously help many U.S. firms to recover after coming through the recession, which has caused a great amount of goodwill impairment as will be discussed in a moment.

Before advancing to examine the real world effects of the current impairment method, a brief examination of the former amortization method and its flaws should be completed. Under the old purchase method, a more consistent amortization charge was deducted from retained earnings over a period of up to forty years. This method often resulted in an overstatement of the amortization which would significantly understate a firm’s earnings. As explained by Michael Davis in his article found in the Journal of Accountancy, goodwill is now a much larger portion of the acquisition price than it used to be when these initial amortization valuation rules were created. Davis cites an example where the amount of recorded goodwill amortization after the forty year period would actually be more than 23 times the amount of the initial goodwill. This method was resulting in a reoccurring net loss for companies such as Time Warner (Davis). This article was published, published in 1992, helped to lead the way for
the new and improved impairment test that does not require a constant write-off of goodwill, providing for a more accurate reporting of net income.

The time has now come to examine the current goodwill impairment accounting method’s effects on firms today. The current method does not require the annual amortization charge; it solely requires firms to test for impairment when events have occurred that have made the possibility of impairment very probable. Due to this requirement, the current recession has unfortunately caused an increased amount of goodwill impairment in several firms. Escalon Medical Corporation is a high-tech corporation that in 2008 reported an increase in revenues of 7.5 percent; however, the corporation still had to report a net loss of nearly $15 million due in part to goodwill impairment charges of $10 million. Goodwill in 2008 was a mere $11 compared to the 2007 goodwill value of nearly $21 million. Escalon Medical properly disclosed the reason for the impairment in the notes of their financial statements in accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets. According to the disclosure, the Drew business segment was valued to be impaired in the amount of $9,575,000 (Escalon). By reporting this loss in the financial statements, investor are properly notified of the decrease in assets while they are also informed of the fact that the loss is not a reoccurring event and therefore should not turn away investments.

Another firm that was negatively affected by goodwill impairment during the recession was Providence Service Corporation. In 2007 Providence Service Corporation reported over $280 million in goodwill; that figure fell to below $133 million in 2008 (Welcome). The company again properly disclosed the details of the impairment charges in the footnotes of the financial
statements. For publicly traded companies in the United States that must abide by U.S. GAAP regulations, the past couple of years dealing with the recession goodwill impairment has had a very large and detrimental impact on net earnings. With the market prices falling in the recession the fair market value of goodwill has dropped dramatically causing the enormous impairment figures.

Goodwill accounting has been characterized by a long history of controversy and debate. From its creation in the 1880’s to current day 2011 the topic continues to be discussed and considered for revision. Improvements have been made to accommodate for the changes in the acquisition process, which for the most part has eliminated the dramatic decrease in net earnings. At the same time the current impairment testing has ensured that companies abide by the conservative property by properly testing for impairment to not overstate the value of an important asset. However, as U.S. firms battle to recover from the recession, the U.S. GAAP stance on goodwill impairment is again being reconsidered. Many firms see the positive opportunities under the IASB standard which allows for goodwill impairment to be reversed if market conditions provide the proper situation. The question and controversy may soon center upon asking why the FASB allows a recession to forever impair a valuable asset even though, years late it may prove to be worth more than its impaired value. The accounting for goodwill has come a long way from its pooling methods and its amortization charges however, by no means has goodwill accounting been perfected. As the implementation of IFRS all around the world continues to spread the FASB may very well continue to examine and revise current U.S. GAAP in order to become more similar to IFRS. Until that time, all one can do is hope for the
market to turn around and release our country from this recession and the burdensome effects of goodwill impairment.
Works Cited


*Escalon Medical Corp*. Web. 28 Nov. 2011. 
