Why Purchased Goodwill Should Be Amortized: An Examination into Japanese Accounting Standard

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WHY PURCHASED GOODWILL SHOULD BE AMORTIZED

~AN EXAMINATION INTO JAPANESE ACCOUNTING STANDARD~

LE VAN LIEN

Conventionally, once positive goodwill is regarded as an asset, it is amortized systematically against income. However, since January 2002, instead of having been amortized, positive goodwill has been impaired officially in the U.S. The International Accounting Standard Committee (IASC) also issued Exposure Draft – ED 3 Business Combination (ED3) in 2003 and emphasized that positive goodwill should have been impaired. Nevertheless, the Japanese Business Accounting Deliberation Council (JBADC) still supposed that purchased goodwill should be amortized systematically in its accounting principle named Accounting Standards for Combination. In this paper, we would like to discuss and express the reasons why purchased goodwill should be amortized. By doing so, we will examine whether we can support the JBADC with regard to the accounting method for purchased goodwill or not. In this paper, only positive goodwill is taken into consideration. Therefore, the structure of this paper is as follows:

a. Issues of accounting for goodwill in Japan.
b. The theoretical meaning of Statements of Financial Accounting Standards No. 142 – Goodwill and Other Intangible Assets (SFAS 142).
c. Necessity of amortization for purchased goodwill.

I. ISSUES ON ACCOUNTING FOR GOODWILL IN JAPAN

In academic papers and other literature, the disadvantages of accounting methods for purchased goodwill in Japan were often criticized by many researchers. The disadvantages are; (1) the nature of goodwill was distorted, (2) the disclosure method did not supply enough information to users[1], and (3) the amortization period was too short and adversely effected the competitiveness of Japanese firms with other companies, which were allowed to amortize purchased goodwill over a longer period[2]. Those disadvantages and other problems of former consolidation accounting principles before 1997 are reasons for consolidated financial statements being criticized for not supplying useful information for decision makers.

1) Yamaji, N. (1997), *"Renketsuchoseikanjo o Meguru Mondai" (Problems in Relation to Consolidation Adjustment Account)* (in Japanese), *Accounting*, Vol.49, No.1, p.59.

2) Umehara, H. (2000), *Norenkaikei no Riron to Seido, (Accounting Theory and Policy for Goodwill)* (in Japanese), Hakutoshobo, pp.151-152. The Japanese Institute of Certified Public Accountants (2000), *Keisankaijitorendo (Accounting Disclosure Trends)* (in Japanese), Chyuo Keizai Sha, p.494.

In the process of international accounting harmonization, the big gaps between Japanese consolidation accounting principles and those of other countries including the U.S made it difficult for global investors when comparing consolidation accounting statements. Therefore, supplying more useful information for decision makers and harmonizing with global accounting standards are aims that JBADC set out to achieve in revising consolidation accounting principles in 1997. However, the first two problems of accounting for goodwill presented above have not been solved yet[3)].

Before 2004, while every other developed country had sufficient accounting standards for combination, Japan had only accounting principles for consolidation that refer to the accounting process of combining parent and subsidiary financial statements. The other combination transactions were treated according to regulations of the Commercial Code. However, the Commercial Code does not stipulate specific regulation; furthermore, what is stipulated by the Commercial Code is very different from accounting standards for combination in other parts of the world such as American Accounting Standards and International Accounting Standards. While combinations of Japanese corporations have increased not only in Japan but also in the world, it is necessary to establish accounting standards for combination. The contents of accounting methods for purchased goodwill according to accounting standards for combinations in 2004 seem to pursue the same ideas as the consolidated accounting principles. Those are; (1) reporting purchased goodwill as an asset, and (2) amortizing it within 20 years.

In relation to accounting issues and the accounting method shown in the accounting standard, research in to the nature, measurement, and the disclosure of purchased goodwill is needed. It is also worthwhile to discuss the accounting method for purchased goodwill when the competition of Japanese firms in comparison with U.S ones is still restricted because of influences of amortization method. The last research question can be understood when analysis of the influence of accounting methods for goodwill on earnings per share are carried out. The impairment method, which is used by the U.S in practice, allows higher assets, stockholders' equity, and net income amounts on the financial statements relative to any other method of accounting for goodwill in cases, where the value of the firms does not decrease. Therefore, capitalization of goodwill without amortization allows the most advantageous financial reporting figures.

Before, the amortization expense of goodwill forced U.S companies to give up bidding transactions when competing with other companies in the world[4)]. Such amortization expense of goodwill may now be influencing Japanese companies.

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3) Le, V. L. (March 2004), "A Closer Look at Factors of Purchased Goodwill in Japan", *Keizai Ronkyu*, Vol.118, pp.105-116.

4) Pensler, S. (1988), "Accounting Rules Favor Foreign Bidders", *Wall Street Journal*, 24, March, p.26.

Although accounting methods for purchased goodwill are not always the same, both the Financial Accounting Standards Board (FASB) and the JBADC confirmed that the accounting methods they proposed would supply better information for decision makers or enhance requirements of accounting information from users. Can the impairment method enhance such requirements? In the following section, the essence of the impairment method proposed by the FASB is taken into consideration.

II. THE THEORETICAL MEANINGS OF SFAS 142

Actually, SFAS 142 – Goodwill and Other Intangible Assets is a result of the process of revising accounting standard for combination transactions in the U.S with the main purpose being to stop managers from abusing the pooling interest method. The background and the accounting setting process can be summarized as follows.

Over three decades from 1970 to 2001, there were two alternative accounting methods accepted for combination according to the Accounting Principles Board 16 in the U.S. Two of them are the purchase method and the pooling interest method. The net income calculated by the pooling interest method is usually higher than that measured by the purchase one[5]. Certainly, the firms, which wanted to report higher net income, would choose the pooling interest method. When managers of those companies realized that it was possible for them to satisfy the 12 conditions for using the pooling interest method, they were willing to spend a lot to achieve such a target. In fact, APB 16 could not stop managers from abusing the pooling interest method[6]. In addition to this reason, the others can be listed below.

1. In order to save time and costs of executives. The complicated contents of the 12 criteria for using the pooling interest method result in the staff of the Securities and Exchange Commission spending nearly 40% of their time dealing with interpreting them[7].
2. In order to supply more useful information about businesses for decision makers. The pooling method does not supply useful information for users. The users of financial statements also indicate a need for better information about intangible assets because those assets are an increasingly important economic resources for many entities and are an increasing proportion of the assets acquired in many business combinations. While the purchase method recognizes intangible assets acquired as much as possible in a business combination,

5) Wyatt, A. R. (1963), *Accounting Research Study No.5, A Critical Study of Accounting for Business Combinations*, AICPA, p.60.
6) Calvin, E. (1977), *An In-Depth Inquiry Into Current Practice In Accounting For Business Combination*, City University of New York.
7) Beresford, D. R. (March 2001), "Congress Looks at Accounting for Business Combinations", *Accounting Horizons*, Vol.15, No.1, p.75.

only those intangible assets previously recorded by the acquired entity are recognized when pooling method is used.

In order to overcome such problems, the FASB proposed to change accounting standard for business combinations. In 1999, the FASB issued Exposure Draft (ED) — Business Combination and Intangible Assets, the basic contents of this ED are; (1) all combination cases should be considered as purchase (ED, par.13), and (2) positive goodwill should be amortized within 20 years (ED, par.42).

After issuing ED, FASB received a strong protest from managers, especially from managers of service and bank industries. Over 60% of letters received from managers were against ED[8]. In such circumstances, FASB still proposed that all combination transactions should be treated by purchase method but purchased goodwill should be impaired rather than amortized. When FASB proposed such requirements, there was no opposition from the public[9]. After that FASB issued SFAS 141 — Business Combination and SFAS 142. If purchased goodwill is not amortized after acquisition, acquiring entity does not bear amortization expense of purchased goodwill at all. That is what used to explain why managers kept silent when FASB proposed that positive goodwill should have been impaired.

The reasons on which FASB based its above conclusion that purchased goodwill should be impaired, are as follows.

(1) Empirically, FASB supposes that many analysts ignore goodwill amortization expense when they evaluate companies; moreover, many entities ignore goodwill amortization expense in measuring operating performance for internal reporting purposes; rather, they hold management responsible for the amount invested in the acquired entity (including goodwill)[10].

(2) Theoretically, as some components of positive goodwill do not decline in value and if they do they rarely do so on a straight-line basis; therefore, if goodwill is amortized over an arbitrary period, accounting information neither reflects economic reality nor supplies useful information for decision makers[11]. Moreover, the components of goodwill, whose indefinite useful life could last as long as the business and are considered a going concern, occupy a lager portion in comparison with that of the wasting asset components after intangible assets are separated from goodwill; therefore, non-amortization of goodwill is thought to be more

8) Beresford, D. R, *op. cit.*, p.74.

9) Nagata, K. (September 2002), "Kigyoketsugo no Kaikeiseisaku — Shinkaikeikijun o Megururonso to Jissho-kadai" (Empirical Theme and Controversy in Relation to the New Accounting Standard — Accounting Policy for Combination) (in Japanese), *Jounal for Security Analysis*, pp.58-67.

10) Financial Accounting Standards Board (FASB) (2001), *Financial Accounting Standards No. 142 (SFAS 142): Goodwill and Other Intangible Assets*, B90.

11) *Ibid.*, B79.

12) *Ibid.*, B82-83.

appropriate[12].

These two reasons will be taken into consideration in our discussions to prove that purchased goodwill should be amortized. Here, the following main points should be made.

a . The essence of SFAS 142 is a result of the process of preparing SFAS 141.

b . FASB was influenced greatly by managers in the process of preparing accounting standards. In such a case, the reliability of accounting information may be lost.

III. NECESSITY OF AMORTIZATION FOR PURCHASED GOODWILL

We will take the first reason that FASB based its conclusion that why purchased into consideration at other opportunity. Here, we would like to discuss the second reason to prove that such araguments are not persuasive enough.

In theory, any long term asset including purchased goodwill can be either amortized or impaired. The theoretical basis for either amortization or impairment are that net income is calculated either by the matching-based approach method or by the valuation-based approach method. Not being the same as other asset items, purchased goodwill is not separable; its value can not be separated from the value of a firm. Its value is also too difficult to separate from general internal goodwill when the impairment method is used. Because of such reasons, in order to limit managers' judgments on accounting information; conventionally, purchased goodwill has been either amortized systematically or written off immediately against surplus. However, the latter method is not often accepted as it does not enhance the accountability of managers. For example, in Great Britain, as purchased goodwill can not be exchangeable, purchased goodiwll is written off immediately against surplus at acquisition (Statement of Standard Accounting Practice 22, par.7). Recently, even though it is not recognized as an asset, it is reported on balance sheet because when it is done in such way, management is held to account when measuring the assets on which a return must be earned "Although, purchased goodwill is not in itself an asset, its inclusion amongst the assets of reporting entity, rather than as a deduction from shareholders' entity, recognizes that goodwill is part of a large asset, the investment, for which management remains accountable"[13].

Breaking from conventional opinions about accounting methods, FASB supposed that purchased goodwill should be impaired. However, we suppose that purchased goodwill should be amortized. The reasons that we are in opposition to FASB about impairment can be presented as follows.

● The first reason is the function of accounting. As everyone knows that one of functions of

13) Accounting Standards Board (ASB), *Financial Reporting Standards No. 10; Goodwill and Intangible Asset*, Appendix III, par.9.

accounting is to match costs and incomes. In the case of purchased goodwill, it should be amortized as a means of matching the costs of securing the income against the income actually received. As time passes, the value of goodwill also decreases because one entity can not maintain better competitive conditions than another forever[14]. The value of goodwill sometimes does not decrease because the present goodwill is not the same goodwill which was purchased before. The current goodwill is largely work of the owners and managers in the intervening period, and is called internal goodwill. When the impairment method is used, the separation of internal goodwill generated after acquisition from purchased goodwill can not be done (FASB also acknowledges this impossibility); therefore, internal goodwill unintentionally is reported as an asset on the balance sheet. So far, internal goodwill is not accepted to be reported as an asset in the accounting frameworks. The Japanese Commercial Code does not allow internal goodwill to be reported on the balance sheet.

● The second reason is the consistency of an accounting system. Like basis for depreciating long-term tangible, those for amortizing goodwill are not usually coincidence with actual exactly. Therefore, as buildings, equipment and other tangible assets are depreciated, positive goodwill should also be amortized[15]. Furthermore, as purchased goodwill generated from consolidation transactions in Japan is required to be amortized; purchased goodwill from combination should be also treated in the same way. This also is consistent with the Japanese Commercial Code, which requires that purchased goodwill should be amortized quickly against to income in order to avoid the arbitrary judgment of managers. In such an accounting environment, positive goodwill should be amortized.

● The third reason is the components of positive goodwill. Six components of purchased goodwill are listed according to FASB[16], they are (1) the excess of the fair values over the book values of the acquired entity's net assets at the date of acquisition, (2) the fair values of other net assets that had not been recognized by the acquired entity at the date of acquisition, (3) the fair value of the "going concern", (4) the fair value of the expected synergies and other benefits from combining the acquiring and acquired entity's net assets and business, (5) overvaluation of the consideration paid by the acquiring entity stemming from errors in valuing the consideration tendered, and (6) overpayment or underpayment by the acquiring entity. Among these components, the third and fourth are thought to be core goodwill, which make benefits of firms higher than other ones. These two components can not be maintained permanently even though their economic lives are indefinite; therefore, when positive goodwill is not amortized,

14) Leak, P. D. (January 1914), "Goodwill; its nature and how to value it", *Accountant*, p.83.
15) Grinyer, J. R., Rusesell, A. and Walker, M. (1990), "The Rationale for Accounting for Goodwill", *British Accounting Review*, Vol.22, No.3, pp.223-235.
16) *SFAS 141*, B102.

but impaired; reporting internal goodwill on the balance sheet will become inevitable. The first two components have certain economic lives and decrease in value as time passes, so they should be amortized against income earned over a certain period. The last two components, which are neither assets nor goodwill, should be written off immediately at acquisition, but the separation of these two components from goodwill can not be feasible. In addition, it is not acceptable to think that goodwill consists only of these two components because originally goodwill is thought to be the super benefit earning of one firm in comparison with the other ones; therefore, these two components do not present that definition of goodwill. FASB supposes that because among components of goodwill, non-core components are excluded as much as possible, and the economic lives of core goodwill components are not definite, positive goodwill should be impaired. However, according to analysis of Japanese Certified Public Accountants[17)], the components called core goodwill occupy only 34.2% of the total amount called purchased goodwill. The remaining percentage (65.8%) belongs to non-core goodwill, whose economic lives can not exist for a long time. Due to impairment of positive goodwill is not accepted even in the U.S, where non-core goodwill components are excluded as much as possible. We analyze and suppose that in Japan positive goodwill officially consists of many non-core goodwill components[18)]. Allthough so far, there is no data available showing what percentage of purchased goodwill in Japan is occupied by core goodwill, we assume that this number in not insignificant. When components of non-core goodwill occupy a large percentage of measured goodwill, it is better that they are amortized because these non-core goodwill components can not exist for a long time.

- Fourthly, it is accountability. According to accountability theory, financial statements not only provide the language and basic for communication between the firms and capital markets but are also documents that monitor and motivate the financial performance of managers. The reason for that is managers always want to maximum their own wealth[19)]. While the impairment method relies heavily on subjective estimates in an uncertain environment, it has not been used as a conceptual basis to support more pragmatic methods for the purpose of accountability. Management under accountability should be required to justify its acquisition of other companies by demonstrating that cash inflows from the acquisition exceed the cash outflows incurred when making the investment. As internal goodwill can not be separated from purchased goodwill and the impairment method is based on the valuation conceptual that is influenced subjectively by managers to a large degree; that is why, the impairment method

17) Wakabayashi, H. and Yonezawa, T. (2002), "Konyunoren no Shisansei to Hiyoka" (Characteristics of Assets and Expense Transferability of Purchased Goodwill) (in Japanese), *Accounting*, Vol.54, No.4, pp.566-575.
18) Le, V. L. (March 2004), *op. cit.*, pp. 105-116.
19) Watts, R.L. and Zimmerman, J.L. (1986), *Positive Accounting Theory*, Prentice-Hall, p.3.

should not be used in practice for the purpose of accountability. When managers spend too much in acquining companies, it grants them virtual immunity against reporting the effects of their mistakes until several years later, at which time the unpleasant task of writing off those debit balance sheet will fall to their innocent successors.

● The final reasons is the possibly reliable about information of impairment of goodwill. To be reliable, information about an item must be representationally faithful, verifiable, and neutral[20]. We submit that information about goodwill under the impairment method meets none of these criteria.

a. To begin with, it is not representational faithful. It is hard to be representationally faithful when the surrogate exists for its own sake. Goodwill after the date of acquisition also fails the test of presentational faithfulness. To measure goodwill, someone will obtain the market value of the firm and subtract out the sum of the market values of the individual net assets of the firm. What is absurd about this algorithm is that it assumes that the residual amounts relate solely to the goodwill purchased as a result of a previous business combination. However, this computed goodwill can easily be tainted with intervening goodwill generated from other activities, events, resources, and social arrangements generated in the interval accounting period. That is why, the calculated number may have little to do with the purchased goodwill.

b. Then, information related to impaired goodwill is not verifiable, for managers will have the opportunity to deny in pairment in many situations. In relation to combination, the desire of managers to report higher net income is not only in the U.S but also in Japan[21]. In the places, where managers usually want to report higher net income within generally accepted accounting principles, they accept impairment for goodwill when the economy turns sour so that managers would look very foolish if they claimed no impairment. The executive will simply find those appraisers and consultants who will provide the desired numbers. Auditors will have no benchmark by which to evaluate the treatments, so they will sign off on almost anything the managers want. When anything goes, nothing is verifiable.

c. The impairment test likewise is not neutral. Instead, it empowers managers to lie through their teeth. Unfortunately, there is nothing neutral about data manipulation.

As positive goodwill is a very special asset, estimating its useful life is very difficult; therefore, amortizing positive goodwill does not exactly reflect its decreased value. However, we suppose that positive goodwill should be impaired due to the previous reasons.

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20) FASB, *Concepts Statement* No.5, pars.75-77.

21) Daigo, S. (1990), *Nihon no Kigyokaikei (Business Accounting of Japan)* (in Japanese), Tokyo University Press. In addition, Japanese firms have also lengthened periods of amortization for goodwill.

IV. CONCLUSION

In theory, purchased goodwill can be treated by different methods; however, any accounting method, which is accepted in theory, may not be employed effectively in practice to enhance the requirements of accounting information. In circumstances where managers try to abuse of using generally accepted accounting methods to boost net income, accounting information may not be useful for decision makers. The impairment method for goodwill proposed by FASB is an such accounting method that empowers managers to lie through their teeth. In addition to this disadvantage, it also conflicts with the function of accounting; it is not consistent with the accounting system; it is not logical in relation to components of purchased goodwill measured according to current accounting principles; and it does not ensure accountability of managers. These weak points are divulged more clearly in Japan. For such reasons, we suppose that purchased goodwill should be amortized rather than impaired.

Besides these theoretical reasons, FASB also based its conclusion on the results of empirical tests. Such results may not be the same in Japan. In order to obtain additional support for our conclusion of which accounting method should be used to supply better information for decision makers, we will carry out empirical tests about purchased goodwill in the following paper.

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