

**American Accounting Association's Financial Accounting Standards Committee**  
**Response to FASB's Invitation to Comment on the**  
**Proposed Statement of Financial Accounting Standards on Business Combinations and**  
**Intangible Assets – Accounting for Goodwill**  
(Limited Revision of Exposure Draft Issued September 7, 1999)

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March 15, 2001

The Financial Accounting Standards Committee of the American Accounting Association (hereafter the Committee) is charged with responding to requests for input from standard setters on issues related to financial reporting. The Committee is pleased to respond to the FASB's invitation to comment on the Proposed Statement of Financial Accounting Standards on Business Combinations and Intangible Assets – Accounting for Goodwill (Limited Revision of Exposure Draft Issued September 7, 1999). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response to the Exposure Draft (ED) incorporates views expressed by previous Committees in prior communications with the FASB on business combinations and intangible assets as well as views specifically related to the new recommendations of the ED. The first section of the response summarizes the Committee's main comments on the ED. The second section provides the Committee's responses to the specific issues in the ED.

### **General Comments and Recommendation**

The Committee believes that two conceptually distinct types of acquisition goodwill exist: wasting and non-wasting. For the former, a consistently applied impairment approach would lead to measurement results that are similar to those obtained by systematic amortization. For the latter, an impairment approach is the only consistent way to measure acquisition goodwill after the initial measurement date. However, the conceptual superiority of an impairment approach must be balanced against the practical implementation problems that would surely be associated with a standard that adopts the specific impairment approach laid out in the ED. As discussed in the Committee's October 2000 letter to the Board, the Committee believes the valuation models on which the proposed impairment approach relies are not adequate in terms of their ability to deliver reliable measures.

Because of the measurement issues associated with using the valuation-model-based approach laid out in the ED, the Committee recommends that the Board retain *pro tem* the systematic amortization approach to measuring acquisition goodwill, with a significantly shorter maximum

amortization period (the academic research literature suggests a maximum period of about 4-10 years); that the Board establish a project (joint with the International Accounting Standards Board) to develop an approach to impairment testing that will produce more reliable measures than would the approach described in the ED; and that the Board require additional disclosures relating to acquisition goodwill. In particular, if the Board retains the impairment approach proposed in the ED, additional disclosures will assist users in understanding the judgments and estimates made by preparers in implementing goodwill impairment tests.

While the Committee agrees that an impairment-only approach is conceptually the most defensible approach for measuring acquisition goodwill after the initial measurement date, as a practical matter of implementation, the Committee views the proposals in the ED as substituting one kind of measurement error for another in measuring acquisition goodwill after the initial measurement. The implementation of existing standards induces measurement error; while periodic amortization provides directionally consistent measurements that capture a decline in the future economic benefits measured by acquisition goodwill, the pattern of measurements is almost surely incorrect. However, the proposed impairment testing approach to measuring acquisition goodwill after the initial measurement date also creates measurement error. The first cause of measurement error that would be induced by the approach described in the ED is the combining of acquisition goodwill with internally generated goodwill in performing the impairment test. The second cause is the use of imprecise valuation models to estimate the values of both the reporting unit and the reporting unit's net assets to determine the residual value of goodwill. Reasonable, conscientious, and well-informed opinions can differ on both the relative magnitudes and implications of these two measurement errors. The ED implicitly takes the position that the latter error is preferred to the former, but does not provide the underlying reasons for this preference.

The first cause of measurement error in the proposed approach to impairment testing stems from the fact that acquisition goodwill cannot be measured separately from other components of total enterprise goodwill subsequent to the acquisition date because it is a residual, the difference between the fair value of the reporting unit and the fair value of the reporting unit's identifiable net assets. As a result, the post-acquisition measure of purchased goodwill includes three components: the [original] acquisition goodwill, internally developed replacement goodwill, and internally developed goodwill that is unrelated to the original acquisition goodwill. The Committee is divided in its views about whether this source of measurement error, taken alone, would be sufficient to undermine the implementation of the impairment approach proposed in the ED. On the one hand, the comingling of internally-generated and acquired goodwill is conceptually similar to what occurs in the impairment testing of other types of assets. On the other hand, an existing *practice* of comingling economically distinct types of future economic benefits does not make the comingling *conceptually* correct.

The second cause of measurement error in the proposed approach to impairment testing derives from the reliance on valuation models. Academic research indicates there is a substantial degree of uncertainty inherent in estimates derived from conventional valuation models. The proposed procedures require that an uncertain estimate of the value of net assets be subtracted from an even more uncertain estimate of the value of the reporting unit to obtain the current value of reporting unit goodwill. The Committee believes the ED implicitly assumes much greater

precision in valuation-model-based estimates than is actually the case. If the Board retains the approach described in the ED, the Committee recommends that the Board supply explicit guidelines for carrying out the impairment test.

Finally, the Committee is concerned that the proposed Statement is not consistent with convergence between U.S. GAAP and international practice (e.g., IAS 22 on Business Combinations and practices in the other G4+1 countries), a stated goal of the FASB. The Committee recommends that the Board consider a joint project, with the IASB, to develop impairment approaches to the accounting for acquisition goodwill that are both conceptually sound and amenable to objective implementation.

### **Responses to the Issues Identified by the Exposure Draft**

***Issue 1: Nonamortization of Goodwill.** The proposed Statement would require that goodwill not be amortized in any circumstance. The carrying amount of goodwill would be reduced only if it was found to be impaired or was associated with assets to be sold or otherwise disposed of.*

- a. Do you agree with the Board's conclusion that goodwill is not a wasting asset if a reporting unit is able to maintain the value of goodwill? If not, why not?*
- b. Do you agree that requiring all goodwill not to be amortized (but to be reduced in value when it is impaired) will result in more useful information than requiring goodwill to be amortized in all circumstances or permitting goodwill to be amortized in certain circumstances? If not, which alternative would be preferable and why?*

a) The Committee does not agree with the implication of the proposed Statement, that if the maintenance of economic benefits associated with acquisition goodwill necessitates ongoing expenditures, then the acquired goodwill *per se* is non-wasting. As the Board indicates (par. 69), most continuing expenditures associated with acquisition goodwill probably replace rather than maintain goodwill. We do not consider replacement goodwill as equivalent to acquisition goodwill; the Committee is divided in its views about the implications of comingling replacement goodwill with the original acquisition goodwill.

Academic research indicates that at least some goodwill is a wasting asset; although research provides no direct evidence on the service life of acquisition goodwill (that is, the length of time over which acquisition goodwill should be amortized), or on the pattern of this amortization, evidence is consistent with the following points. For an average firm, the ability to generate returns exceeding the cost of investment is significantly shorter than either the current maximum forty-year period or the previously proposed twenty-year period. Existing evidence, although indirect, supports a useful life of 4-10 years.<sup>1</sup> Academic research also finds that expenditures on R&D and advertising, among others, contribute to a firm's goodwill at acquisition and at least

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<sup>1</sup> Research includes Penman (1991) and Dechow et al. (1999).

some results indicate that such expenditures are wasting assets.<sup>2</sup> On average, academic research indicates that a significant percentage of business combinations fail to generate all the benefits implied by the acquisition premium.<sup>3</sup> In short, there is no research evidence that acquisition goodwill on average has an indefinite life, and some research that supports the use of a 4-10 year maximum amortization period.

b) Because of the Committee's view that acquisition goodwill is heterogeneous (that is, it contains both wasting and non-wasting elements), we do not agree that non-amortization of all acquisition goodwill necessarily results in *more* useful information. The Committee has cited academic research in past commentaries that does not find a consistently significant relation between goodwill amortization and share price.<sup>4</sup> However, these results do not support complete non-amortization of goodwill for two reasons. First, the current practice of automatic amortization almost surely does not reflect the decline in the future economic benefits associated with acquired goodwill, and this measurement error can preclude a statistically reliable association with share price. Second, providing “information useful for decision-makers” (Statement of Financial Accounting Concepts No. 1) does not imply that share prices are the only or even the main benchmark for determining usefulness.

In support of the view that the acquisition goodwill generated by business combinations contains heterogeneous elements, the Committee points to academic research findings that the premium paid in an acquisition differs by, among other characteristics, the mode of payment (e.g., cash or stock); the presence of other bidders; the year of the acquisition; and the tax treatment of the acquisition. The amount of premium paid for the target directly affects the amount of recorded goodwill. The Committee believes that the broad range of types of business combinations results in an equally broad range of types of acquisition goodwill, some of which is wasting and some of which is not. As a practical matter, neither systematic amortization alone nor periodic impairment testing alone is always superior to the other, although, as previously pointed out, a consistently applied impairment-only approach would be expected to yield measurements that are consistent with systematic amortization in the case of wasting goodwill.

The Committee believes that existing research does not provide evidence which supports the current practice of mechanical amortization of goodwill. The ability to earn returns exceeding the cost of investment varies widely across firms and across time for a given firm. Uniform amortization policies across firms and time are unlikely to correspond to the dissipation of the economic benefits deriving from recognized goodwill. While the Committee believes that amortization of goodwill would be most relevant if it were based on management's superior information and unbiased expectations of useful life (subject to rigorous audit and full disclosure of valuation assumptions), the Committee also points to academic research which indicates a range of useful lives between 4 and 10 years.

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<sup>2</sup> Research includes Lev and Sougiannis (1996). However, evidence is mixed on this point. For example, Barth, et al. (1998) report that estimates of specific brand values published in *Financial World* indicate that over 1993-1996, just under half the brands evaluated showed increases in value estimates.

<sup>3</sup> This research includes, but is not limited to Ravenscraft and Scherer (1987); Kaplan and Weisback (1992); and Healy et al. (1997).

<sup>4</sup> This research includes Jennings, Robinson, Thompson, and Duvall (1996); Vincent (1997); Barth and Clinch (1996); and Amir et al. (1993).

**Issue 2: Goodwill Impairment Test.** *This proposed Statement would require that goodwill be tested for impairment when events or circumstances occur indicating that goodwill of a reporting unit might be impaired. A reporting unit is defined as “the lowest level of an entity that is a business and that can be distinguished, physically and operationally and for internal reporting purposes, from the other activities, operations, and assets of the entity.”*

- a. *Do you agree that goodwill should be tested for impairment at the reporting unit level? If not, please describe the level at which testing for impairment should occur.*
- b. *Is the guidance in paragraphs 10 and 11 on determining the reporting unit sufficient? If not, how should it be modified and why?*
- c. *In order to test goodwill for impairment at the reporting unit level, paragraph 11 states that goodwill and all other assets and liabilities of an acquired entity that will be employed in or relate to the operations of a reporting unit must be assigned to the reporting unit as of the acquisition date. What, if any, concerns do you have with that requirement? How might those concerns be addressed?*

The Committee does not agree that goodwill should be tested for impairment at a reporting unit level which differs from the segment level. We believe that the Board fails to provide a sound conceptual basis for introducing an additional organization level, the “reporting unit,” into the external reporting for goodwill. Based on the Board’s analysis that led to SFAS No. 131, it is difficult to justify another reporting level for purposes of business combinations.

The Committee also believes the definition of reporting unit is vague and imprecise, and the reporting requirements are inconsistent. The proposed Statement requires that goodwill be reported at acquisition at the segment level because information “at a level lower than the segment level would be of little value to users because they would not have access to performance data (earnings and cash flow) at that lower level” (par. 115). However, the proposed Statement requires that disclosures of goodwill impairment be made at the reporting unit level, which might differ from the segment level. The impairment disclosures would likewise be made without the performance data that were missing at the time of the acquisition of goodwill; the Committee thus questions the usefulness of such reporting.

**Issue 3: Timing of Benchmark Assessment.** *This proposed Statement would require that a benchmark assessment be performed whenever a reporting unit is created or the net assets of a reporting unit are changed substantially due to an acquisition and the goodwill of that reporting unit is significant in relation to the carrying amount (book value) of its other net assets. In addition, a benchmark assessment would be performed whenever a reporting unit has been created or significantly modified by a reorganization of an entity’s reporting structure and the goodwill of that reporting unit is significant in relation to the carrying amount of its other assets. This proposed Statement would require those benchmark assessments to be completed within one year of the date of the acquisition or at the date of the reorganization that gave rise to the*

*benchmark assessment. Is that time frame appropriate to perform a benchmark assessment as described in paragraph 16? If not, what time frame would be appropriate and why?*

The Committee has no comment on this requirement.

***Issue 4: Impairment Triggers.*** *Paragraph 18 provides examples of events or circumstances that would require goodwill of a reporting unit to be tested for impairment. Are those indicators of potential impairment appropriate? If not, which of the examples should be modified and how? Are there additional examples that should be included? If so, please describe.*

The Committee questions the economic basis for two related impairment triggers, f) and g):

- f) A decline in the market capitalization of an entity (or reporting unit) below the carrying amount of its net assets (including goodwill) that is other than temporary.
- g) A significant and other-than-temporary decline in the market price of the common stock of an entity (or reporting unit).

Both f) and g) refer to a decline in market capitalization that is “other than temporary.” Implementation of these guidelines requires either omniscience or a specific definition of the duration of an “other than temporary” decline. The Committee does not believe that declines in market value, regardless of duration, are appropriate triggers.

***Issue 5: Impairment Recognition.*** *This proposed Statement would require that goodwill impairment loss be recognized if the implied fair value of a reporting unit’s goodwill is less than its carrying amount. The implied fair value of goodwill would be determined by subtracting the fair value (with certain exceptions) of the recognized net assets of the reporting unit excluding goodwill from the fair value of the reporting unit. The process of determining the implied fair value of goodwill is similar to the process of determining the amount of goodwill that would be recognized if the reporting unit was purchased at its fair value but the purchase price allocation was restricted to the net assets, other than goodwill, recognized prior to the business combination.*

- a. *Do you believe that the proposed impairment test is operational and that it will adequately capture a decline in the value of goodwill? If not, please explain why not and describe an operational impairment test that would adequately capture a decline in the value of goodwill.*
- b. *Do you agree with the Board’s conclusion that subtracting the fair value (with certain exceptions) of recognized net assets from the fair value of the reporting unit results in an impairment test that strikes an appropriate balance between costs and benefits? If not, what alternative would you suggest and why?*

a. While the Committee supports the idea of impairment testing for acquisition goodwill, we do not believe the proposed impairment test is operational for several reasons. First, the guidelines for determination of what constitutes a reporting unit are vague, as discussed in Issue 2. Second, there are significant valuation issues for the reporting units. Because valuation is not a precise

science, the valuation of any business entity using standard valuation methods as outlined in the ED results in a range of values conditional on the assumptions. Sensitivity and scenario analyses are standard parts of any valuation analysis and the resulting range of reasonable estimated values for an entity is likely to be wide.<sup>5</sup> Additional problems that arise with valuing individual reporting units include the determination of interdivisional profits and the allocation of joint costs (e.g., pension costs, environmental clean-up costs, capital costs). For example, if reporting unit A “sells” a significant portion of its output of goods or services to reporting unit B (or reporting units B and C, etc.), how are the “revenues” of unit A valued? The determination of such transfer prices is the subject of significant academic study with little consensus. Transfer prices and joint cost allocations matter for the impairment testing approach described in the ED because most valuation models require either cash flows or earnings as inputs.

There is also variance inherent in the fair valuing of the reporting unit’s assets and liabilities, including the identifiable intangibles defined in the ED. Although this variance may be less than that of valuing the reporting unit, significant uncertainty remains about the measurement of the net assets as evidenced by the difficulty operationalizing the replacement cost accounting requirement years ago.

The Committee is concerned that the ED does not acknowledge or address the degree of uncertainty inherent in these estimates and the potential impact of that uncertainty on the residual measurement of goodwill. The proposed procedures require that an uncertain estimate of the value of net assets be subtracted from an even more uncertain estimate of the value of the reporting unit to obtain the current value of reporting unit goodwill. The difference between the resulting value and the carrying value of goodwill determines any impairment. If the Board adopts an impairment test along the lines proposed, then the Committee believes the Board should provide more explicit guidelines for concluding whether goodwill is impaired. For example, guidelines may specify that the reporting unit write down goodwill only if the most conservative estimate of residual value is less than carrying value. The ED implicitly ascribes too much precision to the value estimates that will result from the valuation of both the reporting unit and the net assets and provides too little guidance for handling the uncertainty in the valuation process.

The Committee pointed out in its October 2000 comment letter that the measurement of goodwill as a residual after the acquisition date incorporates acquired goodwill, pre-business combination internally-generated goodwill, and changes in both acquired and internally-generated goodwill since the acquisition. Some members of the Committee remain concerned about the inconsistent treatment of internally generated goodwill for firms (or reporting units) with purchase-accounting acquisitions opposed to firms without such acquisitions. The Board acknowledges this issue (par. 69) but some members of the Committee do not agree with the Board’s position that it is acceptable to mix acquisition and internally-generated goodwill for some (acquiring) firms but not for others. The Board also indicates (par. 70) that by mixing acquisition goodwill with internally-generated goodwill, the impairment test would be failed “infrequently,” as though this is an argument in favor of impairment testing. The Committee does not believe that *ex ante* infrequent failing of an impairment test is consistent with the goal of providing information useful to users of financial statements.

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<sup>5</sup> For more detail on valuation models, please refer to the Committee’s October 2000 letter to the Board.

**Issue 6: Effective Date and Transition.** *The provisions in this proposed Statement would be effective for fiscal quarters beginning after issuance of a final Statement. Neither early application nor retroactive application would be permitted. As described in paragraph 38, pro forma information would be disclosed in the period of adoption and thereafter until all periods reflect goodwill accounted for in accordance with this proposed Statement. Are those effective date and transition provisions appropriate? If not, how should they be modified and why?*

The Committee has no comment on this issue.

**Issue 7: Transition for Existing Goodwill.** *This proposed Statement would not require that existing goodwill be tested for impairment upon adoption of the final Statement unless an indicator of impairment exists at that date. However, this proposed Statement would require that the benchmark assessment described in paragraph 16 be performed for all existing reporting units with goodwill within six months of adoption.*

- a. *Should this proposed Statement require that all existing goodwill be tested for impairment upon adoption of the final Statement? If so, what time frame should be allowed for completion of those impairment tests?*
- b. *Is six months adequate time to complete the “transitional” benchmark assessments on existing reporting units? If not, why not and what time frame should be provided?*

The Committee has no comment on this issue.

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