Goodwill: The Illusion of Value?

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Abstract

This paper examines the illusion of value generated by the booking of accounting goodwill and its impact as a driver of top line and bottom line growth in an otherwise satiated market. "Packaging is everything" is the popular phrase. "It holds truth regarding the illusion of value." (The Illusion of Value, January 12, 2015)

Keywords: Accounting Principles Board (APB), Accounting Standards Codification (ASC), American Institute of Certified Public Accountants (AICPA), Financial Accounting Standards Board (FASB), fair market value (FMV), goodwill, growth, impairment, intangibles, market share mergers and acquisitions (M&A), profits, profit maximization, Securities Exchange Commission (SEC), sustainability, tangibles.

Terms and Acronyms

10K – SEC required annual financial reporting form
10Q – SEC required quarterly financial reporting form
AICPA – American Institute of Certified Public Accountants
APB – Accounting Principles Board (the precursor to the FASB)
ASC – Accounting Standards Codification
BCG – Boston Consulting Group – Quad Model: Mix Max/HiLo Framework: Market Share/ Market Growth Matrix (Adapted)

a) **Cash Cows** – BCG mature company/product/service component with large market share, but little growth opportunities where cash flows are used to fund faster growing components
b) **Dogs** – BCG units, products or services which no longer provide required growth, profits, cash flows, and have little market share.
c) **High Potential** - BCG model high growth components that are gaining in market share
d) **Winners** – BCG model components with the highest market share and market growth

CONs – FASB Concept Statements
FASB – Financial Accounting Standards Board (successor to the APB)
FMV – Fair Market Value
GAAP – Generally Accepted Accounting Principles
SEC – U.S. Securities and Exchange Commission

Introduction

This paper reviews the accounting rules (Generally Accepted Accounting Principles - GAAP) regarding goodwill, asset impairment, profit maximization and the sustainability paradigm relative to the life cycle phenomenon. The Financial Accounting Standards Board (FASB) under its accounting authority, specifically in its Accounting Standards Codification (ASC) governing the accounting for goodwill, sections 350-10, 350-20 and subtopic 850-30, addresses the issues of, and issues associated with, goodwill.

In particular, paragraph ASC 350-10-05-1 provides guidance on financial accounting and reporting related to goodwill. Paragraph ASC 850-30-30-1) Measurement of Goodwill, posits:

…the acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b) where (a) is the aggregate of the consideration transferred; the fair value of any non controlling interest in the acquired; the business combination achieved in stages and (b) is the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Topic.

The Accounting Standard Codification (ASC 350-10-20) also describes Goodwill, "…as an asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized."

In simpler terms, goodwill is a long term asset of an intangible nature that arises when a company acquires another business in its entirety. Goodwill is calculated as follows:

Figure 1: The Goodwill Calculation

Cost of the Acquisition

- FMV of Tangible Assets Acquired (Fair Market Value)
- FMV Value of Intangible Assets Acquired Individually Identifiable
- Value of Assumed Liabilities of the Entity Acquired

Goodwill

Or, even more simply, goodwill is the net asset value of assets acquired in excess of their Fair Market Value that cannot be individually identified.

Facts and Historical Points – The Rules

Many of the issues in dealing with goodwill arose when the former Accounting Principles Board (predecessor to the Financial Accounting Standards Board – FASB) in its Opinion APB No. 16, 'Business Combinations', permitted two methods of accounting for acquisitions: 1) the purchase acquisition rule where goodwill had to be calculated, and 2) the pooling acquisition rule which permitted firms to simply merge like kind account balances (no write-up of asset values to fair market value). APB 16 required the pooling method to be used, but then laid out a series of rules which were difficult for firms to meet in adopting the pooling method. Unless all the pooling combination rules could be met, the purchase method had to be used. The effect was many firms had to use the purchase method for business combinations. APB No. 16 was superseded with the FASB issuance of its Statement No. 141, 'Business Combinations', which only permitted the purchase method to be used for accounting for business acquisitions. To date, the purchase method of accounting for business combinations stands.

The rules for goodwill, APB 17, 'Intangible Assets', required this asset class to be expensed via systematic amortization. But, superseding APB 17, SFAS 142, 'Goodwill and Other Intangible Assets' required the use of the impairment charge method of expensing Goodwill. That is, goodwill was not to be ratably amortized anymore; rather it was to henceforth be impaired. That is, it was not to be expensed unless and until impairment occurs. The old goodwill rules required goodwill to be systematically amortized (expensed) over no more than 40 years. The challenge here is that the impairment rules in force today provide wide discretion in determining when and if goodwill becomes impaired. To this end, the Financial Accounting Standards Board (FASB) Project Update draft for amending the impairment rules made on September 12, 2016, appears to still provide wide discretion in the calculation of any goodwill impairment. (FASB, 2016).

Additionally, FASB Concepts Statement 2 (CON 2), (May 1990), Qualitative Characteristics of Accounting Information, in paragraphs 91 – 93, addresses the matter of making the conservative choice when deciding accounting matters.

91. Nothing has yet been said about conservatism, a convention that many accountants believe to be appropriate in making accounting decisions. To quote APB Statement 4: Frequently, assets and liabilities are measured in a context of significant uncertainties.

Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets.
This has led to the convention of conservatism. . . . [Paragraph 171]

92. There is a place for a convention such as conservatism—meaning prudence—in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference "that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets" introduces a bias into financial reporting, conservatism tends to conflict with Significant qualitative characteristics, such as representational faithfulness, neutrality, and comparability (including consistency). To be clear about what conservatism does not mean may often be as important as to be clear about what it means.

93. Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board emphasizes that point because conservatism has long been identified with the idea that deliberate understatement is a virtue. That notion became deeply ingrained and is still in evidence despite efforts over the past 40 years to change it. The convention of conservatism, which was once commonly expressed in the admonition to "anticipate no profits but anticipate all losses," developed during a time when balance sheets were considered the primary (and often only) financial statement, and details of profits or other operating results were rarely provided outside business enterprises. To the bankers or other lenders who were the principal external users of financial statements, understatement for its own sake became widely considered to be desirable, since the greater the understatement of assets the greater the margin of safety the assets provided as security for loans or other debts.

Discussion of the Issues

In recent times, we see a tremendous growth in the appearance of goodwill on the balance sheets of many companies in order to show top line and bottom line growth in an otherwise satiated market. Such acquisitions often result in material goodwill appearing on the balance sheet as a percent of total assets and/or off balance sheet market values. It was reported in The Wall Street Journal that companies in the U.S. could have recorded more than $8 trillion in intangible assets (including goodwill) according to Leonard Nakamura of the Federal Reserve Bank of Philadelphia (2016). Monga states, "… that's nearly half of the combined $17.9 trillion market capitalization of the S&P 500 index (Monga 2016). Bernard Condon of Associated Press (2016) indicates that goodwill on the balance sheets of the Standard & Poor's 500 index ballooned to $2.5 trillion. "That is 50% more than at the end of the last deal boom in 2007 according to FactSet," (Condon, 2016). Part of this move to recording large goodwill and intangible amounts on balance sheets may be driven in part by CON 2, para 3, as noted above. Paragraph 3 seems to alter past practices in determining the choice of values to be recorded.

The effect of the move to booking large goodwill amounts according to data provided by R.G. Associates, a research firm that focuses on accounting matters, shows that in 2002 following a surge in acquisitions, write-downs cut pre-tax earnings by 21%, while goodwill write downs in the twelve months following the end of 2007 reduced S&P 500 earnings by more than 38% (Condon, 2016).

Condon further identifies the issues with goodwill values. He posits that the average premium over market prices offered by acquirers in 2015 was 38%, and for health care companies, the premium offered was 57% (Condon, 2016). The below Figure 2 presents reported goodwill of a number of large public firms as a percent of market value.

Figure 2: Goodwill as a Percent of Market Value

Source: (Thurm, 2012)

In a similar study by Nugent et al (2016), the top 100 largest companies listed on U.S. stock exchanges were examined relative to comparing goodwill to total assets. Out of the top 100 firms, 14 firms were eliminated as having financial statements significantly different from the remaining 86 firms. Those eliminated firms were principally banks and insurance companies. A list of the 86 firms remaining and data from their latest 10Ks filed with the U.S. Securities and Exchange Commission through June 15, 2016 appears as Appendix A.

In Appendix A, it can be seen that 27 of the 86 firms examined had goodwill measuring more than 20% of total assets, with 12 firms having goodwill in excess of 30% of total assets, and 3 with goodwill in excess of 40% of total assets. Viewing one large firm that has been in the news of late, AT&T, it can be seen AT&T had total assets of approximately $403 billion and goodwill of approximately $105 billion (the largest goodwill dollar amount amongst the firms examined) on its December 2015 10K report. Previous to its DirecTV acquisition for approximately $49 billion (plus the assumption of debt), its goodwill was shown as $70.3 billion on total assets of $308 billion, or approximately 23% of total assets in its May 5, 2015 SEC 10Q report. So with the acquisition of DirecTV, AT&T's goodwill increased by approximately $31 billion within one year! One year! That $31 billion increase in goodwill in AT&T's 2015 10K report by itself, would have qualified as number 9 on the list of the largest firms with the largest goodwill amounts. Moreover, as of October 2016, AT&T's approximate market value is $250 billion, which means its goodwill approximates 42% of its market value.

Figure 3: Abridged Table of Firms with the Largest Percent of Goodwill

(See Appendix A for a complete list of firms)

Co Name	STK SYM	Date	Tot Assets	G/W	G/W % of Tot Assets
Express Scr	ESRX	December	53,243	29,227	0.549
Time Warn	TWX	December	63,848	27,689	0.434
CVS Health	CVS	December	93,657	38,106	0.407
United Hea	UNH	December	111,383	44,453	0.399
procter & (	PG	June 30,20	129,495	47,316	0.365
General Dy	GD	December	31,997	11,443	0.358
Mondelez I	MDLZ	December	62,843	20,664	0.329
Honeywell	HON	December	49,316	15,895	0.322
Walt Disne	DIS	October 3,	88,182	27,826	0.316
United Tec	UTX	December	87,484	27,301	0.312
HP	HPQ	October 31	106,882	32,941	0.308
Oracle	ORCL	May 31,20	110,903	34,087	0.307
Tyson Fooc	TSN	October 3,	23,004	6,667	0.29
IBM	IBM	December	110,498	32,021	0.29
Pfizer	PFE	December	167,460	48,242	0.288
Anthem	ANTM	December	61,717	17,562	0.285
3M	MMM	December	32,718	9,249	0.283
Lockheed M	LMT	December	49,128	13,576	0.276
AT&T	T	December	402,672	104,568	0.26

Source: 10K Reports filed with the SEC and for SEC data collection and percent
Calculations; Esther Ibrahim, and Almas Ali, Graduate Assistants,

Texas Woman's University School of Management, August 2016

As an asset, goodwill appears to help the acquirer in sustaining the appearance of increasing enterprise value via increased assets, and in the firm's ability to show top and bottom line increases through additional revenues with no concomitant penalty in the form of additional expenses (goodwill impairment/expenses). What develops is a pattern of constraints wherein a primary, almost single focus on sustained growth and profit maximization ultimately leads to entity non-sustainability by placing gross overpayments for assets above net asset fair market values on the balance sheet. That is, long term sustainability may be negatively impacted in entities that grossly overpay for net assets acquired above fair market value by showing such overpayments as assets versus period or transaction expenses. In concept, it could be said that managements and Boards of Directors are induced to grossly overpay for net assets acquired because there are material gains: enhanced enterprise valuations, positive stock price performance, an increased ability to borrow or raise other capital, and an ability to reward managers and employees with ever increasing 'in the money' options, etc. But the question remains, do such overpayments above fair market value for net assets acquired enhance or limit sustainability?

Monga (2016) in The Wall Street Journal cites the work of economist Carol Corrado. Corrado shows that companies were investing approximately 14% of the private sector gross domestic product into non-physical assets (intangibles) in 2014. The investment in tangible assets (physical matter) in 2014 was approximately 10%. Corrado posits this was a reverse of the situation of 40 years ago where investment in tangible assets was 13%, and intangibles were 9%. Clearly technological advancements have had an impact in the type of investments made; but 40 years ago, goodwill had to be systematically amortized (expensed) over not more than 40 years – a dramatic difference with the goodwill impairment (expense) standards of today.

Why might managements see the gross over payment above fair market value for net assets acquired as a tool of value? Simply, when in the second half of the life cycle in any industry, it becomes harder and harder to capture new un-captured customers. Hence growing a top and bottom line via organic growth becomes much more arduous than in the first half. And, as Wall Street principally only rewards top and bottom line growth and market share gains, firms in maturing markets need to show growth and increases in the top line and bottom lines above all else. And with goodwill not having to be systematically expensed, managements have a window of opportunity to drive for the brass ring – top line and bottom line growth, with no concurrent material acquisition overpayment expenses.

This willingness to grossly overpay for net assets acquired above fair market value is even more likely so if CEO and CFO tenures are examined. Fortune Magazine reported that for the 500 largest companies in the U.S., the mean tenure for a CEO is 4.9 years (Sonnenfeld, 2015), and for CFOs, The Wall Street Journal reported the mean tenure was 5.6 years (Monga, 2015). Hardly a tenure long enough to worry about sustainability and the long term!

In the market as a function of time, if a primary focus on profit maximization is followed driven by an understanding of mean tenure times for senior officers, it almost universally will lead to corporate decline or demise – short term growth and profit maximization versus longer term sustainability via enhanced research and development efforts which have current period costs associated with such activities. And if we consider the life cycle of a business enterprise, here too we see relatively very short lives as in the mean tenure times of the CEO and CFO.

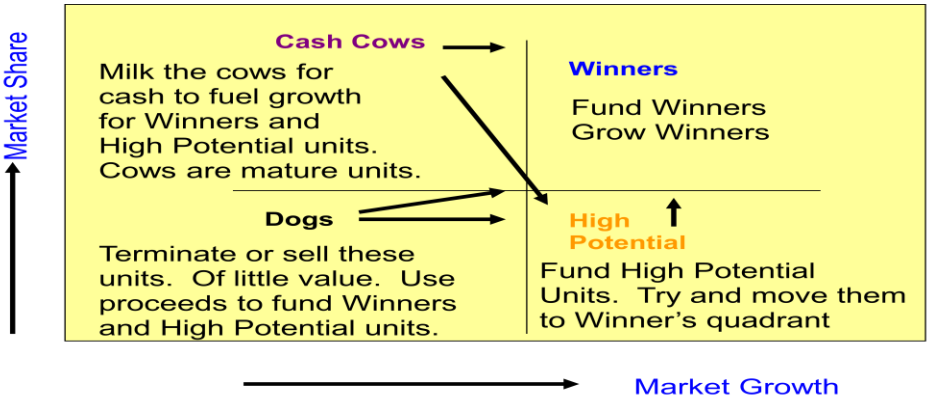
Senge (2013) references the 1980s research work of Royal Dutch Shell Corporation on the lifespan of corporations (see also Arie De Geus, *The Living Company*). The average life expectancy of a large multinational corporation (Fortune 500 or its equivalent) is between 40 and 50 years. A full 33% of the companies listed in the 1970 Fortune 500 list had either vanished by 1983, been acquired or merged, or divided into individual elements. The life expectancy of all firms regardless of size is 12.5 years. Based on Shell's criteria, only 40 corporations were discovered to have been in existence more than 150 years. (Shore, 2013).

Eight (8) out of ten (10) entrepreneurs who start businesses fail within the first 18 months (Wagner, 2013).

Larry Greiner of Harvard (1972) has written extensively over the years on the evolution and revolution of firms as they grow and mature. Greiner points out that in his model, the final stage in an enterprise's transition is a question mark. That is, the last stage is at the discretion of its respective business leaders – the entity does not in and of itself have to pass. Rather, the enterprise's next stage is decided by its leadership decisions. Will the leaders invest for the future, thereby creating a sustainable future? Or will they maximize near term growth and profits by buying like kind enterprises to capture customers and profits at a time when margins and growth are being squeezed, but pay well above fair market values for net assets acquired? Moreover, with the loose impairment rules of today regarding charges to goodwill, have the standard setters incentivized managements to overpay for intangibles by permitting such overpayments to reside on the balance sheet as an asset versus as an expense on the income statements (a debit is a debit)?

Bruce Henderson, the founder of the Boston Consulting Group (BCG, 1970), provided another great model for determining when it is time to alter strategy (product or service offering mix) in order to sustain oneself (Reeves, et al, 2014). Henderson developed this framework in the era of the conglomerate (a core component of the conglomerate dynamic was to balance counter cyclical businesses in order to optimize growth, profits and cash flows for the entire enterprise). What Henderson identified was that businesses should attempt to have a portfolio of companies/products/services wherein each strived to achieve market share and market growth. He realized that offerings would over time move into and out of market favor, and businesses needed to see this change and act accordingly in order to sustain themselves. Henderson developed his model on a min/max or hi/low quad (four box) framework. An adapted form of the Henderson model appears below:

Figure 4: Henderson's (BCG's) Market Share/Market Growth Model (adapted)



In the BCG modified model above, basically an asset reallocation model, the enterprise attempts to reallocate resources on a continuous basis to components where market share and growth opportunities are greatest – not necessarily to pump up top and bottom line growth via acquisitions of other mature or declining franchises for short term gains.

Conclusions and Recommendations

More assets on balance sheets today are of an intangible nature (including goodwill) than at any previous time. Clearly, technological changes may be at the center of this shift in asset form, but it also appears that accounting standards have created a large inducement for companies to 'puff the value wares' by permitting for an overpaying for net assets acquired in a business combination without such goodwill assets being systematically amortized (expensed).

Inasmuch as the impairment standards still provide wide discretion in their calculation even in the latest draft, in order to return to the accounting underpinning of making the conservative choice, it is recommended that a return to systematic amortization of goodwill replace the current impairment standard. Moreover, it is recommended that the systematic amortization of goodwill take place over a significantly shorter period than previously stipulated when life cycles tended to be longer. Here it is recommended that a Twenty (20) year amortization period become the standard. This shorter amortization period reflects the shorter life cycles of technology solutions, which often have life cycles of eighteen (18) months or less.

Additionally, the proposed systematic amortization of goodwill and possibly other intangibles should reduce the inducement for managements to acquire net assets for acquisition prices far above fair market values.

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Appendix A: List of the 86 Largest Firms Listed on U.S. Stock Exchanges, Forbes Magazine,

June 15, 2016 (Excludes Banks and Insurance Companies)

Sources: Forbes Magazine, SEC 10 K reports, and for data collection and Goodwill Calculations by:

Esther Ibrahim and Almas Ali, Graduate Assistants at Texas Woman's University Graduate school of Management

Total Assets and Goodwill

Sample n=86

(table in millions of $s, Years ending in 2015 - months vary)
Sources: Forbes Magazine, June 15, 2016 and www.sec.gov)

Median based on G/W % = 11%, G/W

Mean Based on G/W % =14.8%

Co Name	STK SYM	Date	Tot Assets	G/W	G/W % of Tot Assets
Express Script Holding	ESRX	December 31,2015	53,243	29,227	0.549
Time Warner	TWX	December 31,2015	63,848	27,689	0.434
CVS Health	CVS	December 31,2015	93,657	38,106	0.407
United Health Group	UNH	December 31,2015	111,383	44,453	0.399
Procter & Gamble	PG	June 30,2015	129,495	47,316	0.365
General Dynamics	GD	December 31,2015	31,997	11,443	0.358
Mondelez International	MDLZ	December 31,2015	62,843	20,664	0.329
Honeywell international	HON	December 31,2015	49,316	15,895	0.322
Walt Disney	DIS	October 3,2015	88,182	27,826	0.316
United Technologies	UTX	December 31,2015	87,484	27,301	0.312
HP	HPQ	October 31,2015	106,882	32,941	0.308
Oracle	ORCL	May 31,2015	110,903	34,087	0.307
Tyson Foods	TSN	October 3,2015	23,004	6,667	0.290
IBM	IBM	December 31,2015	110,498	32,021	0.290
Pfizer	PFE	December 31,2015	167,460	48,242	0.288
Anthem	ANTM	December 31,2015	61,717	17,562	0.285
3M	MMM	December 31,2015	32,718	9,249	0.283
Lockheed Martin	LMT	December 31,2015	49,128	13,576	0.276
AT&T	T	December 31,2015	402,672	104,568	0.260
Twenty First Century Fox	FOXA	June 30,2015	50,051	12,513	0.250
Walgreens	WBA	August 31,2015	68,782	16,372	0.238
Johnson Controls	JCI	September 30,2015	29,673	6,824	0.230
AmerisourceBergen	ABC	September 30,2015	27,736	6,123	0.221
Phillip Morris International	PM	December 31,2015	33,956	7,415	0.218
Cisco systems	CSCO	July 25,2015	113,481	24,469	0.216
HCA Holdings	HCA	December 31,2015	32,744	6,731	0.206
PepsiCo	PEP	December 26,2015	69,667	14,177	0.203
Cardinal Health	CAH	June 30,2015	30,142	6,018	0.200
Comcast	CMCSA	December 31,2015	166,574	32,945	0.198
Delta Air lines	DAL	December 31,2015	53,134	9,794	0.184
McKesson	MCK	March 31,2015	53,870	9,817	0.182
Dow Chemical	DOW	December 31,2015	68,026	12,154	0.179
Macy's	M	October 31,2015	22,086	3,897	0.176
Merck	MRK	December 31,2015	101,779	17,723	0.174
Johnson & Johnson	JNJ	September 27,2015	133,266	21,629	0.162
World Fuel Services	INT	December 31,2015	4,549	675	0.148
General Electric	GE	December 31,2015	492,692	65,526	0.133

Humana	HUM	December 31,2015	24,705	3,265	0.132
Coca-Cola	KO	December 31,2015	90,093	11,289	0.125
AVNET	AVT	June 27,2015	10,799	1,278	0.118
Enterprise Products Partners	EPD	December 31,2015	48,952	5,745	0.117
Berkshire Hathaway	BRK-A	December 31,2015	552,257	62,708	0.114
United Continental Holdings	UAL	December 31,2015	40,861	4,523	0.111
Intel	INTC	December 26,2015	103,065	11,332	0.110
Alphabet	GOOGL	December 31,2015	147,461	15,869	0.108
Cigna	CI	December 31,2015	57,088	6,019	0.105
Energy Transfer Equity	ETE	December 31,2015	71,189	7,473	0.105
FedEx	FDX	May 31,2015	36,551	3,810	0.104
Verizon	VZ	December 31,2015	244,640	25,331	0.104
Dupont	DD	December 31,2015	41,166	4,248	0.103
Plains GP Holdings	PAGP	December 31,2015	24,142	2,405	0.100
Microsoft	MSFT	June 30,2015	174,472	16,939	0.097
Marathon Petroleum	MPC	December 31,2015	43,115	4,019	0.093
Archer Daniels Midlands	ADM	December 31,2015	40,157	3,688	0.092
UPS	UPS	December 31,2015	38,311	3,419	0.089
American Airlines Group	AAL	December 31,2015	48,415	4,091	0.084
Caterpillar	CAT	December 31,2015	78,497	6,615	0.084
WalMart	WMT	October 31,2015	205,144	17,051	0.083
Kroger	KR	January 31,2015	30,497	2,304	0.076
Phillip 66	PSX	December 31,2015	48,580	3,275	0.067
Amazon.com	AMZN	December 31,2015	65,444	3,759	0.057
Halliburton	HAL	December 31,2015	36,942	2,109	0.057
Boeing	BA	December 31,2015	94,408	5,126	0.054
Ingram Micro	IM	October 3,2015	12,831	532	0.041
Home Deport	HD	February 1,2015	39,946	1,354	0.034
General motors	GM	December 31,2015	194,520	5,947	0.031
TJX	TJX	October 31,2015	10,989	309	0.028
Best Buy	BBY	January 31,2015	15,245	425	0.028
Safeway	SWY	January 3,2015	13,377	330	0.025
Sears Holdings	SHLD	August 1,2015	13,186	269	0.020
Apple	AAPL	September 26,2015	290,479	5,116	0.018
Chevron	CVX	December 31,2015	266,103	4,588	0.017
Deere	DE	October 31,2015	57,947	726	0.013
INTL FCstone	INTL	September 30,2015	5,070	58	0.011
NIKE	NKE	May 31,2015	21,597	131	0.006
Sysco	SYY	June 27,2015	17,989	2	0.000
Exxon Mobil	XOM	December 31,2015	336,758	0	0.000
Ford Motor	F	December 31,2015	224,925	0	0.000
ConocoPhillips	COP	December 31,2015	97,484	0	0.000
Valero Energy	VLO	December 31,2015	44,343	0	0.000
Target	TGT	January 31,2015	41,172	0	0.000
Costco	COST	August 30,2015	33,440	0	0.000
Lowe's	LOW	January 30,2015	31,721	0	0.000
Tesoro	TSO	December 31,2015	16,332	0	0.000
CHS	CHSCP	August 31 2015	15,228	0	0.000
TECH DATA	TECD	Jan 31,2015	6,136	0	0.000