

**Week 1 – DQ 2**

**Under current GAAP, goodwill is recorded when purchased.**

**Debate:**

**Present arguments in favor or against the capitalization of "purchased" goodwill. You may consider tying your arguments to theories of capital maintenance and/or the Conceptual Framework.**

***Response #1***

I have a few thoughts on purchased goodwill. On one side I can agree with capitalization and on the other I cannot.

If two companies, A and B, are in contract negotiations and company A offers to purchase company B for \$100,000 when assets and appraisers agree that the company is only worth \$50,000 then I would say that company B did a great job during negotiations and company A should not be able to capitalize and depreciate the difference in cost just because company A strongly feels that one day this purchase will make sense.

On the other hand I think of real estate transactions. If I were to use the same example as above and company A were to offer company B \$100,000 for a property that only appraised for \$50,000 then no one would argue that company A purchased property from company B for \$50,000 more than the appraised value. In addition company A would still be able to capitalize the difference and depreciate the property over a period of time.

I know that goodwill is a little more complicated than that because it can include intangible which are difficult to value but I can definitely see an argument to both sides.

***Response #2***

I am in favor of the capitalization of purchased goodwill, but not internally created goodwill. I feel purchased goodwill fits the criteria of being part of the expenditures to acquire an asset as it is agreed upon between two companies being residual difference of fair market value and purchase price of the business. As such it can be considered part of initial cost associated with keeping the assets in good working order (an example is acquiring a company to create a new department within your company and with that acquisition comes the knowledge of its employees). In order for a company to properly identify the asset value of their balance sheet, goodwill would need to be taken into consideration and disclosed separately from fair market value cost of the acquired company in order to ensure the qualitative characteristics of the balance sheet.

### ***Response #3***

Accounting rules typically do not allow "unpurchased" goodwill to be listed on the balance sheet as an asset, and our analysis indicates this is correct if the balance sheet is to give the value of present property rights. But some accounting rules rather mysteriously allow "purchased goodwill" to be recorded as an asset. This is reminiscent of the old joke about a country bumpkin who comes to New York where a con man sells him the Brooklyn Bridge. Can the buyer then put the Brooklyn Bridge on his balance sheet since he "purchased those rights"? Surely the point is that the buyer cannot purchase a right which the seller does not own in the first place. Hence "purchased goodwill" is no more a present property right than unpurchased goodwill since the seller had no such property right to sell.

### ***Response #4***

Capital expended to "purchase" such a non-right should not be recorded as an owned asset but as a debit to equity. Some accountants have courageously argued for this correct procedure, e.g., George Catlett and Norman Olson in *Accounting for Goodwill*.

The amount assigned to purchased goodwill represents a disbursement of existing resources, or of proceeds of stock issued to effect the business combination, in

anticipation of future earnings. The expenditure should be accounted for as a reduction of stockholders' equity. [Catlett and Olson 1968, 106]

Reference:<http://www.ellerman.org/2010/02/the-fatal-flaw-in-finance-theory-capitalizing-goodwill/>