Mr. Kuhaneck:

Congratulations on being named Interim Technical Director. You join a long list of well qualified people who have held that position.

I would like to give my comments on Identifiable Intangible Assets and Subsequent Accounting for Goodwill. My comments represent my own thoughts and opinions. I cannot even claim to represent other members of my household as my wife and two cats seem to claim higher status. However, in my professional life as the CFO of a company, I am a user of financial statements.

I have seen goodwill impairment and valuation allowances against all deferred income assets and viewed those companies no differently than they were before these accounting gymnastics. I believe both of those adjustments should be ignored when analyzing financial statements as they do not represent anything other than the result of a checklist and the opinion of a risk manager at the firm signing the opinion.

Let’s think about the goodwill impairment model in the context of other GAAP. GAAP has been treated like the refrigerator of ideas that various chefs over the years add to and take away from as they prepare their version of accounting standards. Over time, it is hard to tell if anything tasty can be made of what is left. Some items are discarded, some items are left behind in the vegetable drawer for years. At some point, someone opens the door and realizes something is smelly. Today, someone has decided maybe the goodwill impairment model stinks.

**Comparison of the Goodwill impairment Model to Other Well-Established GAAP concepts:**

We used to amortize goodwill over about 40 years or less. That seemed OK for a while until some people decided they didn’t like the amortization hitting earnings and started backing it out of earnings. It’s non-cash! That amortization did not represent the result of any operating process or other identifiable event. Others claimed 40 years was arbitrary, it can’t be right! Why 40 years? Maybe
goodwill is worthless on day one! Maybe it lasts forever and grows in value! We don’t know what it is! Let’s just leave it alone and ignore it on the balance sheet! Good idea! But what if something happens and we can clearly tell that goodwill is not longer worth its carrying value? I guess we need an impairment model.

But before we go into the impairment model, let’s think about the old amortization model we discarded. It was not optional. The only thing that was optional was the life of the goodwill and in theory, at least, it had to be reasonable in the eyes of the firm attesting to the financial statements and not longer than 40 years.

Why should we be concerned that the life of goodwill is somewhat ambiguous? Aren’t most asset lives somewhat ambiguous? I am not sure why goodwill is any different than other assets. Should the ambiguous lives of tangible assets be treated differently than intangible assets? What about cars (they last longer now than they did 20 years ago). What about machinery that has a 10-year life and was installed in the 50’s and has been maintained, and runs better today than it did 70 years ago? Or what about a building? Why do we arbitrarily depreciate buildings over 30 or 40 years when they can last much longer? A building can go up in value, yet we depreciate them down in value! How is a building different than goodwill?

Is it because it is intangible? Why is building depreciation different than goodwill amortization? It is clearly not because we can accurately determine the life of a building and not the life of goodwill. It is clearly not because the value of a building may go up and would make a systematic write down of the asset value over time unreasonable.

Maybe we discarded goodwill amortization in favor of doing nothing (with an impairment model kicker) because someone asked us to and it sounded reasonable. We thought about it, albeit in isolation from other assets like buildings; we did outreach; we deliberated and came up with what seemed rational and reasonable for this one question about this one asset.

Did we reconcile the conceptual basis of not amortizing goodwill with continuing to depreciate assets over fairly arbitrary lives? If so, I would not have to write this letter.

The Relative Accuracy of the Goodwill Impairment Model:

I agree with the concept of needing an impairment model if we do not have an amortization model. We may need an impairment model even if we have an amortization model. What I don’t necessarily agree with is the model we have. Each part of it seems logical and rational. However, more assumptions do not necessarily improve accuracy. Maybe we need a model that can predict the future better. If we could accurately predict the future, we could ‘amortize or impair’ goodwill as its value is consumed. That way goodwill’s varying value would be zero when it no longer provides future value.

I apologize if this ‘predict the future’ model smacks of the ‘matching principle’ which may be one of the leftovers in the refrigerator. But I do not believe in a model that writes down an asset in a period after that asset has demonstrated it is now worthless. So from a timing perspective, the existing model is not perfect or even good. The existing model will impair goodwill when ‘we paid too much in the past and our plans in the past didn’t work out’. There was an ‘event’ in the past, let’s write it off now. The impairment should have been in the past.
Within the existing model, we use lots of tried and true calculation methods. Like discounting. Do we always discount impairments? No, we can’t discount a tangible asset impairment. Because a tangible asset is tangible. In the current model, we estimate growth rates of price and volume to determine future cash flows. We estimate values of lots of other tangible assets. Is any of this accurate? Do all these detailed assumptions and estimates make the estimate more accurate? I posit then answer is NO. Heck, if we knew how to estimate all those things, we would not have paid so much and created all that goodwill.

Every day, rational investors determine the value of public businesses. One is a seller and one is a buyer. They both think they got a deal when they buy/sell. Who was right? What really happens is one or both of them were irrational. One may have needed liquidity so sold below their belief of the stock’s value. Does that distressed value represent the value of the company?

Part of the fallacy of accuracy is that the market is rational on the reporting date. I might go so far as to say that the market is never rational at any given point in time but it is only rational over the long term. The impairment model is a point in time valuation. Sometimes it works but when an impairment is made, it can include a reconciliation to an irrational amount. If financial statement users really understood what was going on with goodwill impairment, they would question the credibility of the rest of the financial statements.

Here are some of my opinions on the questions:

1. What is goodwill. I believe goodwill is a journal entry. Period. I could say that it represents future benefits of technology, profits from future customers, etc. but that value exists in entities that don’t have goodwill on their books as well. The only difference between an entity before it is acquired and after is a journal entry. If we are trying to ‘make the world perfect’ let’s make everyone record goodwill and go full fair value for everything. But we aren’t, so let’s admit that goodwill is a journal entry needed to balance a purchase transaction. Maybe the problem is the name ‘Goodwill’. Maybe if you don’t know exactly what it is and you need a place to put the balancing item, it should be called ‘WITTB – What It Takes To Balance’ or ‘OFTO – Overpaid For This One’. I prefer WITTB.

2. Do the benefits of the information provided by the current impairment model justify the cost? Heck no. The cost is high for a simple journal entry. The benefits are next to zero. I always exclude goodwill impairment from any analysis to determine whether a customer or vendor is a viable entity. That being said, I would back out goodwill amortization as well. In almost all equity analysis reports I read and in our internal analysis we look at receivables, payables, current debt (whatever that is) and cash flow being generated by the entity. Since the cash flow statement is useless because it would rather talk about the kind of cash flow (if we knew the real difference in investing and financing were, we wouldn’t have a project discussing debt with characteristics of equity). So, I start with net income and back out some journal entries that I refer to as ‘journal entries per share’ like depreciation, amortization and fair value adjustments (if I can find them). Then I subtract cash items like estimated cash income taxes, capex, debt payments, etc. to get expected cash flow. Cash is cash, the rest is just journal entries. Trying to tease out cash from the income statement is my goal. Then I can see if that cash flow is enough to support the net liabilities.
I do get one benefit out of the goodwill impairment model. If there is a goodwill impairment, I can ask myself, did I see this coming? Unfortunately, the answer is either ‘yes’ and we have had the customer on our watch list or ‘no’ and I realize they may have had a tough year with the auditors. Whatever the answer, my analysis ends up the same and I draw my own conclusions. Remarkably enough, I review analyst reports of public customers and large vendors. When they are trying to get enterprise value, they follow the same process. I am looking at short term, they are looking at long term. We both use a version of EBITDA starting with net income and back out the big journal entries. Just like banks that loan against cash flow (non ABL facilities), EBITDA, whatever that is, is a key financial metric.

All the gymnastics around reporting units is comical. That does not make the flawed calculation more accurate, it just makes it more complicated and expensive. What do I care where a journal entry is allocated? I back it out anyway. I see that as adding insult to injury, making something already useless even more expensive. I don’t want receivables by reporting unit, there is not debt due by reporting unit, I don’t care about goodwill by reporting unit. I guess it seemed like a good idea at the time.

3. Do you support an amortization model – Yes. Simple, understandable and no less accurate than the impairment model, I would argue possibly more accurate. Enough said.

4. What kind of life do I support? Any life is better than zero. In the History section of the ITC, on page 4, you state that ‘goodwill may not be infinite lived but it is indefinite lived’. So we chose a an indefinite life in our current mode? I don’t know what the real life is (probably different in each situation), but even the board admitted the life was not infinite. Just because they could not figure out a reasonable (not exact) life, they punctured and let it be infinite. Epic Fail. The PCC didn’t know what the life was either. They debated a few lives. Tom started with 15. That got unanimous support and was voted on. Problem solved. Then Tom thought a shorter period would be better because there would be fewer impairments if the amortization period was shorter. That got unanimous support and was voted on. My favorite argument at the time was ‘I can divide by 10 easier than I can divide by 15 so I like a 10 year life’. That is how sausage is made.

Is 10 years the best life? Maybe not but it is better than doing nothing because we could decide on the perfect solution. It is better than a zero life. Daryl at the time suggested immediate write off. That had some support. It is an interesting idea. The problem was we all knew goodwill had a life of something, we just did not know exactly what it was. So we discarded immediate write off. That would have been as bad as an indefinite life.

If you want people to understand financial statements and important items, and if you think the period and method are important, disclose the method and life and keep it simple. If users really saw what went into some of the more ridiculous calculations or presentations (impairment, the cash flow statement, etc.) they would shake their heads in disgust and your
credibility would be shot. Now is the time to do the right thing, right the prior wrong, clean out the refrigerator of the stinking stuff in the corner.

5. Does my view change on having an impairment model depending on the life? I guess if you chose a one year life I would say we do not need an impairment model. Otherwise my view stays the same. Keep it simple. Don’t over complicate it. Don’t worry that people will not think you are smart if you don’t invent something they can’t understand. That isn’t really true – they just think you are crazy.

6. Would investors receive decision useful information if an entity justifies a different amortization period? Decision useful information, probably not unless they are seeking information about what motivates management. The equity analysts would like a better measure than net income if some companies have amortization and others don’t when they calculate the P/E ratio. I adds inconsistency. Poor them, life is tough. If they only knew that there is no conceptual basis for what is included in net income.

Before you discard that statement, remember we all admit there is no conceptual basis behind what is in other comprehensive income. Either Net Income or Total Comprehensive Income has no conceptual basis. I tend to believe there is more of a conceptual basis for Total Comprehensive Income (everything, including all the FV measures we recognize) than there is for Net Income (some FV measures in, others out, with no discernable logic about which is which). Don’t get me started on decision useful information in financial statements.

7. Do the amendments in 2017-04 help? Yes, somewhat. But they don’t get at the heart of the issue. They are not enough.

8. Does 2011-08 help? Not really. It was an interesting idea but from a practical perspective, risk conscious audit firms (whoever they are) tend to believe something is different.

9. Do I support removing an annual test? Yes, remove it. If you try to have an events driven test that will be a can of worms. Either always have a test or never have a test. Keep it simple whatever you do.

10. Do I support an entity level test? Again, do you present entity level financial information? If not, does that simplify things? By simplify, I mean ‘will this make sense to the user’? For someone who has 20 entities in the UK and 100 elsewhere, I don’t know if entity level makes a lot of sense or is helpful. If that is where you think simplification is, get rid of impairment entirely and go with 100% amortization. I believe we should have amortization or the test at whatever level the goodwill is recorded and not lower. There is no need to ‘assign’ goodwill to lower levels. That is pretending some goodwill science exists and is logical, practical and accurate.

11. What other changes to the model should the board consider? I think the Board often gets caught up in the details. Step back and look at what you are proposing and ask yourself ‘is this
simple now’? If you need to understand reporting units, entities, actuarial calculations or lunar trajectories, I am going to say it is not simple. The litmus test for simple is if the average user (let’s say a banker or other creditor) can explain it and get the basic concept or mechanics correct if they had the basic information. Regardless of what you think or have been told, that is not reasonably possible with the current model. Accounting firms have specialists and most others think it is a mess. I am not sure if any 2 people would get the same answer given the same facts on any impairment calculation.

12. I would support Amortization Only and to a much lesser extent amortization with impairment. I don’t have the grid reproduced here but in my opinion, the problem with testing and reporting units is the level at which financial statements can be prepared. If a subsidiary only set of statements are prepared, with goodwill, it makes sense that that goodwill should be tested at the subsidiary level. Remarkably enough, this makes push down accounting a GAAP requirement because parent only statements are not allowed. If you are reporting goodwill, there should be some way of writing it off if needed whether that is amortization or ‘impairment’. I do not think GAAP should require the level at which goodwill is recorded. But at whatever level goodwill is recorded, amortization or impairment should be recorded as well. Again, don’t overcomplicate it.

Part 2 – ‘Customer Related Intangibles’ do NOT exist:

When I get my car fixed, I go to a place that will fix it correctly the first time and not take advantage of me. Or maybe I got to the closest place that is most convenient. Which of these should be customer related intangibles to the car dealership? None. The car dealership doesn’t fix my car, a person does. That person is not me – the customer. That person is an employee.

GAAP specifically prohibits worker based intangibles like assembled labor force or anything other than a contract for future service. But for some reason, I would pay more for a dealership that has good qualified mechanics that fix cars right the first time. They would have more volume, possibly get higher prices and have more customer loyalty. Because of their people.

That is true of a clothing shop with good sales people. It is true of a company that sells it products over the phone where the customer service group knows the customers and make customers feel valued. Is that the name on the front on the building (would be a trade name intangible)? Is that ‘stickiness’ of the customer to the business really the business? Would it continue to exist if all the customer service or mechanics turned over and a new group came in that acted differently? No. What is currently perceived as a customer related intangible or a ‘customer list’ is not a customer related intangible, it is a workforce intangible which is prohibited.

What could not be done directly (workforce intangible) is being done indirectly (customer list). Customer lists are not the intangible, the relationship is the intangible. Relationships are with people not companies. If relationships are with companies, that is the trade name.

Newspapers, magazines and websites have customer lists. A list of customers that pay you for a subscription. Even that kind of list can be related to the people creating the content. At the extreme, imagine a portrait painter who has a large business painting portraits. He sells his business with his
name. What if a name like his does not justify the value paid? Is that his customer list of existing clients who get portraits painted? What is the business worth without the painter? How is that so completely different from the good mechanic, the good customer service rep on the phone or the good reporter on the TV or newspaper? It isn’t, all of them are people who generate future business and profits (goodwill). People are workforce based intangibles.

I don’t feel the need to answer a lot of specific questions about a concept I completely disagree with. I will say, you can’t sell people so I am not aware of these intangibles trading separately. Decision useful information would be generated if we quit calling things customer related intangibles since that is decision misleading.

Should we extend the PCC alternative to all companies. I don’t have a problem with that. If you had to come up with a principle behind the PCC alternative, you can say GAAP was inconsistent in the past by claiming such a thing as customer related intangibles existed and the PCC alternative illuminated the errors of the past. If you subsume all intangibles into goodwill, that would be a complete cop out and you should turn in your badge and leave the building. This is not about giving up and taking the easy way out. Don’t let what is rotten in the refrigerator continue to stink, start cleaning it out. Goodwill impairment and customer lists are a great place to start.

To paraphrase someone who understood that we should embrace ambiguity as a path to achieving great things – ‘We choose to do these things not because they are easy, but because they are hard. They are the make and measure of our skills and abilities.’ Rise up to the challenge of improving GAAP. This is a step.

Next is to deal with presentation, not recognition and measurement. And I must say, the current thinking on presentation is way off the mark. That is a topic for another day.

As usual, if you have any questions or would like further clarification, more opinions, my thoughts on other comprehensive income or presentation, fell free to email or call me.

With kind regards, I am your devoted servant,

Sincerely,

George W. Beckwith