Schumpeter

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WHEN it comes to concepts with inappropriate names, goodwill is near the top of the list. Instead of benevolence and big-heartedness, it provokes irritation and theological feuds among financial types. Goodwill is an intangible asset that sits on firms' balance-sheets and represents the difference between the price they paid to buy another firm and their target's original book value. If you think that sounds too abstract to care about, the numbers are huge. Total goodwill for all listed firms worldwide is $8trn, according to Bloomberg. That compares to $14trn of physical assets. Dry? Yes. Irrelevant? Far from it.

Controversy has boiled ever since takeovers took off in the 1980s. Today, the treatment of goodwill matters for almost all companies. Take the top 500 European and top 500 American firms by market value. Some 50% have a third or more of their book equity tied up in goodwill. The biggest goodwill carriers are the deal-junkies: AT&T ($143bn), Anheuser-Busch InBev ($137bn), General Electric ($82bn) and Berkshire Hathaway ($81bn). Apple is a rarity: it has little goodwill because it has eschewed big deals.

So it is of some consequence that on August 29th the International Accounting Standards Board (IASB), which frames the rules in most countries apart from America, said that as part of an ongoing review it would consider a shake-up. The existing rules are almost identical in America and Europe—when an acquirer buys a firm, it books the goodwill on its balance-sheet. It then periodically reviews this sum in an impairment test. Has the acquisition flubbed its market-share targets or got flabby? If so the goodwill is adjusted down by the firm, overseen by its auditors (it can only very rarely be adjusted up). The revised value is based on new forecasts of the expected cashflows. The write-off appears as a loss on the buyer's income statement and life goes on.

Just as the stock of goodwill sitting on balance-sheets has become vast, so have the write-downs. For the top 500 European and top 500 American firms by market value, cumulative goodwill write-offs over the past ten years amount to $690bn. There is a clear pattern of bosses blowing the bank at the top of the business cycle and then admitting their sins later, splattering their income statements in red. Vodafone has written off $52bn of goodwill in the past decade, a similar sum to its current market value.

The present system for tracking all this has two disadvantages. First, measurement. When assets like factories or software are booked on balance-sheets, the value bears some relationship to a number that can be validated externally. But there is a queasy circularity about goodwill: the more companies bid up the price of acquisitions, the bigger the asset they can book. Meanwhile, the process of impairment is horrendously subjective. Most buyers fold their acquisitions into their existing businesses, making it hard to separate them in order to measure their performance. And there is usually a gap of several years before companies own up to mistakes. Investors have already reacted long before then so the accounts become a lagging indicator, of diminished utility.

The second problem is comparability. Goodwill relates to intangible assets: a firm's culture or strategic presence in a growth market, say. But these are not normally recognised on balance-sheets. Take two identical firms, with the same operations, cashflow, debt, strategy and value. The firm built through past acquisitions would have a bloated asset base. As a result its ratio of debt to assets would look healthier. Its shares would look artificially cheap compared with their book value. And it would have a lower return on equity. Sophisticated investors adjust for this distortion. But retail investors and computers may not. Hans Hoogervorst, the IASB's chairman, has noted that many of the computers behind factor funds, a popular type of statistically driven investing, don't adjust properly for goodwill. It is an alarming insight.

One Utopian answer to the goodwill conundrum would be for all firms to recognise all their intangible assets on their balance-sheets. That would eliminate the comparability problem. It might also please economists who fret that accounts do not capture the economy-wide shift from tangible to intangible assets. This was discussed at the gathering of central bankers at Jackson Hole on August 23rd-25th. But the high-wire game of calculating the market value of entire companies is what the stockmarket does. The goal of accounts is more modest: to measure past performance and provide useful information that helps investors. Allowing firms to constantly estimate their own market value would duplicate the job of investors and also be a dog's breakfast.

A potential fix for the measurement problem, which the IASB is considering, is a return to the practice of writing off a fixed amount of goodwill every year, rather like screws are depreciated over time (this was the approach in America and Europe before the 2000s). But this involves spurious precision: no one has any idea how fast a company depletes its brand per year. And since goodwill is not a cash charge, reported profits would diverge from cashflows. Investors would ignore whatever annual charge the accounts showed. This is how Warren Buffett advised Berkshire Hathaway shareholders to view these costs back in the 1990s.

Impaired judgment

For all its flaws, the status quo is the best available approach. It can be tinkered with sensibly—the IASB is considering asking firms to give more detail about their unrecognised intangible assets. In time this might help develop a coherent methodology for valuing them. But for now the key is for investors to be clear about their objectives. If you are scrutinising a company's history and working out whether it has wasted vast sums on deals, then goodwill and write-downs are highly relevant. But if the objective is to assess a company's prospective ability to service debts or create value for its shareholders, goodwill does not matter much at all and should be ignored. After a long boom and lots of pricey deals, the write-downs are coming. A discerning eye, not an accounting revolution, is what is required to interpret them.

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