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Goodwill

Goodwill is one of the most misunderstood items on the balance sheet. Legally, the government forces you to create a "goodwill" entry on the asset side of the balance sheet when you buy another company for more than its book value. The presumption is that you overpaid for your purchase and that is, usually, a bunch of bull.

Two companies, A and B, get into a negotiation. "A" will not sell for less that what it considers fair value and "B" will not buy for more than what it considers fair value. If we are in a market economy, the presumption should be that B paid fair value and A accepted fair value. Hundreds or thousands of shareholders concur to make the deal a reality. And what can be inferred from the fact that the book value does not match the market value of the company? That the book value does not reflect the real value of the company!!!

Now, let's suppose you buy some shares in a stock exchange. How often are the shares priced at book value? Hardly ever. But you are not forced to open a "goodwill" account for each company whose shares you buy. Why is it that at the precise moment when you buy one half the shares plus one share of a company, that you must change your accounting methods?

The next question to ponder is why the book value is so far away from the real market value. Supposedly the accountants that created GAAP were trying to be as accurate as possible, why did they fail? Let's take one simple example. You set up a business in very cheap farmland, say in Santa Clara Valley where most of your neighbours are growing grapes. You picked the place because it is close to a good university and only an hour or so from some major metropolitan centers. A few years go by and all of a sudden you are in down town of tony Palo Alto in the middle of Silicon Valley and real estate sky rockets. You keep your few acres of land on your books at purchase price, a few thousand dollars, when today you could sell it for many million dollars. Of course, when your company gets bought out, the buyer pays the real price and, according to the GAAP accounting, he has overpaid!

Denny
"Demand creates queues. Supply gets rid of them."

Software Times

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Finance and Investment

Historical Cost Vs. Current Cost: Accountants Wrestle with Reporting Question

One of the foundations of American accounting is the Historical Basis approach, under which assets are presented on the balance sheet at their value at the time of acquisition. But in an era marked by the widespread use of complicated financial instruments and risk management strategies that may render yesterday's prices obsolete, some people are asking if historical cost should be replaced by a current-cost system. It could lead to more accurate financial reporting. Or it could lead to chaos.
http://knowledge.wharton.upenn.edu/articles.cfm?catid=1&articleid=348