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GOODWILL UNDER SCRUTINY: HOW THE SEC IS INCREASINGLY TARGETING GOODWILL IMPAIRMENTS AND WAYS TO REDUCE RISK

Following nearly a decade of strong M&A activity, companies' balance sheets reflect historic levels of goodwill. This increase has led to an accompanying uptick in goodwill impairments, in both rate and size, as goodwill becomes a larger share of companies' total assets. The SEC's Division of Enforcement is increasingly wading into this technically complex and judgment-laden area, and is scrutinizing how, when, and why companies record changes to the value of their goodwill and intangible assets. Companies should monitor these developments and assess their own accounting practices to better understand where key risks lie.

By Jason H. Smith *

It is not difficult to imagine even savvy investors shrugging their shoulders when reading the "goodwill" entry on a company's financial statement. For many, that figure represents intangible assets, such as brand recognition and customer loyalty, that are too abstract to meaningfully quantify. Although the concept of goodwill may seem amorphous, it is more relevant now than ever. The aggregate book value of all goodwill assets booked on listed companies' balance sheets globally is $8 trillion — a staggering figure considering that these firms' total physical assets amount to $14 trillion.[1]

In brief, goodwill is the premium a company pays to acquire another business over and above that target's original book value. It represents management's belief that the acquiring company will recoup the overpayment through cost savings, a larger customer base, expanded brand recognition, greater efficiencies, and other strengths.

The sizeable amount of goodwill on companies' balance sheets is the byproduct of a larger trend of increasing M&A activity, which reached its third-highest year on record in 2018.[2] In 2011, the amount of goodwill disclosed worldwide on companies' balance sheets slightly exceeded $4 trillion. By the end of 2017, that number had nearly doubled.[3]

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[1] The Economist, *As Good as It Gets* (Sept. 1, 2018), *available at* https://www.economist.com/business/2018/08/30/disputes-over-goodwill-can-seem-arcane.

[2] Financial Times, *M&A Bonanza Poses an Impairment Threat for Investors* (May 16, 2019), *available at* https://www.ft.com/content/f8bf5fe4-77af-11e9-be7d-6d846537acab.

[3] Brand Finance, *Global Intangible Finance Tracker (GIFT™) 2018 – An Annual Review of the World's Intangible Value* (Oct. 16, 2018), *available at* https://brandfinance.com/images/upload/gift_1.pdf.

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