As markets fall, goodwill hard to maintain

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By late 2008, David Adams could tell with one glance at his books that the market had handed him a problem.

The chief financial officer at Groupe Aeroplan Inc. was carrying almost $3-billion in goodwill on the flight-reward company's balance sheet, most of it residue from its 2005 spinoff from ACE Aviation Holdings Inc. But the entire market capitalization of Aeroplan's stock, which had been close to $5-billion in early January, had tumbled to $1.3-billion by late November. According to the market, the entire company was worth less than half of the value of its goodwill alone.

Accounting rules and regulatory directives were crystal clear: The discrepancy between the market value and the goodwill was a flashing red warning signal that the goodwill was probably no longer worth what Aeroplan's books said it was. The company was compelled to run an impairment test. The result: a $1.16-billion writedown against earnings, which the company reported last month.

"It was actually pretty simple," Mr. Adams said. "The securities regulators are driving the bus on this."

Aeroplan is hardly alone: Plunging asset values, slumping earnings prospects, rising borrowing costs and a key 2002 accounting change have left an unprecedented amount of increasingly hard-to-justify goodwill on corporate balance sheets, prompting Canadian and U.S. regulators to remind companies to take a hard look at their goodwill. The result has been a wave of big-money writedowns that might still be in its early stages.

A recent report from Desjardins Securities showed that companies on the S&P/TSX composite index had a combined $168-billion of goodwill on their balance sheets at the end of the third quarter. Since then, TSX companies have announced at least $13-billion in goodwill writedowns, including charges of more than $1-billion each at Aeroplan, Nortel Networks Corp., CanWest Global Communications Corp., Great-West Lifeco Inc. and Gerdau Ameristeel Corp.

Financial executives argue that the writedowns are non-cash charges that don't reflect on a company's operations. But analysts warn that the implications may be more severe.

By definition, a goodwill writedown reflects a permanent impairment in an asset's future cash flow potential, which could imply a risk to dividends. Analysts warn that the writedown of assets may put at risk debt covenants and hurt a company's ability to raise funds, and that it also amounts to an admission by management that it overpaid to acquire assets.

"I would argue that if you're holding the stock [of a company with high exposure to goodwill], you should be concerned about it," said Peter Gibson, vice-chairman and strategist at Desjardins.

While goodwill is a fuzzy concept, in strictly balance sheet terms it represents the gap between the fair value of an asset and the price its owner paid to acquire it. When a company acquires assets at a price above their fair value, the excess is recorded as goodwill - the implication being that the asset's prospects for future growth in cash generation justify the premium paid, and thus have value in themselves.

Goodwill writedowns typically accelerate during bear markets, as companies adjust their assessment of the cash-generating potential of assets purchased during better times to reflect the new, much less rose-coloured reality. But this time around, goodwill charges are headed for unprecedented heights, because regulators changed the rules governing the accounting for goodwill since the last bear market.

Before 2002, companies were required to amortize goodwill on their books annually, so it would eventually shrink to nothing over time. In 2002, U.S. and Canadian accounting regulators decided to allow companies to carry goodwill perpetually on their balance sheets, but required them to run an annual test to determine if there were any underlying change in valuations that had undermined those goodwill estimates, known as a goodwill impairment.

If warning indicators crop up in between annual impairment tests - such as a sharp drop in market value, or a serious deterioration in business conditions - regulators have directed companies to test immediately to see if a goodwill writedown is required.

During the downturn of 2001, before the rule change, goodwill writedowns in the U.S. totalled $51-billion (U.S.). That number has already been easily eclipsed in this recession: Two companies alone - Sprint Nextel Corp. and Courier Corp. - combined for $54-billion in goodwill writedowns.

"I'm not sure there is any historical precedent, " said Karen Parsons, an accountant and business adviser at consulting firm Grant Thornton LLP in Toronto. "This is really the first test."

Compounding the rule change is the fact that during the 2002-07 bull market, companies routinely paid big premiums for acquisitions. Now, many of the growth assumptions that justified those premiums have been turned on their heads, as market values collapsed and economic prospects withered.

This has left many companies carrying goodwill on their books that hasn't been depreciating and, over the space of a few months, has rapidly become impossible to justify.

"If you made an acquisition in the past two or three years and you expected that business to keep growing, or if you paid with your own shares and they have gone down, that could indicate an impairment of goodwill," Ms. Parsons said.

Anthony Scilipoti, an analyst at Veritas Investment Research Corp., thinks resource-based companies look especially exposed to goodwill writedowns because they bought assets in the past few years based on high assumptions for future commodity prices.

Still, he said the current depressed stock prices might already have priced in the risk of goodwill writedowns.

"Very often, it is a lagging indicator," Mr. Scilipoti said. "The stock price has already gotten hit because the underlying business fundamentals have turned sour. Then you question [whether] the goodwill is impaired."

Given the already discounted values for stocks in the markets, some experts feel that companies may be better off absorbing goodwill writedowns now, cleaning up their balance sheets and better positioning themselves for the next upturn - especially since the 2002 removal of the amortization rule for goodwill may have made writedowns ultimately unavoidable.

"At some point in time, most organizations are going to be faced with a goodwill impairment," Aeroplan's Mr. Adams said. "You may as well just get it out of the way."

THE GREAT DEBATE

Canadian and U.S. securities regulators recently reminded companies that they must consider their sinking stock prices as an indicator of a potential impairment of goodwill - a directive that may be accelerating the number and size of goodwill writedowns. Much like the mark-to-market question surrounding troubled mortgage-backed securities in the banking sector, this regulatory position has sparked a debate: Is it fair?

"That's the million-dollar question," said accounting expert Karen Parsons of Grant Thornton LLP. "One viewpoint is that [the market value] is the fair value today, there's an impairment, and if you don't take it, you're not reporting appropriate information to the market.

"On the other end of the spectrum, there are people who would say this is just a very unusual circumstance, it's not an indicator of the market on the long term, and we shouldn't be putting as much emphasis on it," Ms. Parsons said.

Wayne Brownlee, chief financial officer at Potash Corp. of Saskatchewan, said one big concern for companies is that goodwill tests triggered by slumping markets may be feeding a vicious circle.

"It's a continual spiralling down or self-fulfilling prophesy on valuation," he said. "The more you write down, the more the earnings come down, and you have to go back and reassess [goodwill] every quarter. It just keeps pulling [the stock price] down and down."

Some experts, however, argue that the market's pricing of many of these stocks already reflects investors' belief that a goodwill impairment exists - that the business case for the assets has deteriorated sufficiently to have blasted a hole in assumptions about future growth.

"The investor has already decided that an impairment exists. The market is making a determination of value," said Richard Crosson, national head of the business valuation group at Ernst & Young LLP.

"You would need more persuasive reasons [to avoid taking a goodwill writedown] than simply the market is irrational."

By the numbers

Here's a list of some of the biggest goodwill writedowns among Canadian companies since the beginning of 2009:

Great-West Lifeco$1.35-billion

Gerdau Ameristeel$1.2-billion

Nortel Networks$1.2-billion

Group Aeroplan$1.16-billion

Kinross Gold$994-million

Teck Cominco$844-million