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Goodwill Hunting: Balance Sheets' Latest Torment

By LESLIE P. NORTON |

HERE IS THE LATEST INSTALLMENT IN THE ONGOING heartbreak called corporate-earnings releases.

In coming months, don't be surprised to see more charges against earnings -- and resulting losses -- owing to goodwill impairment. Last week, NYSE Euronext (ticker: NYX) recorded a $1.34 billion fourth-quarter loss, as it took a charge related to the New York bourse's 2007 purchase of its European counterpart. The charge involved a write-down of $1.59 billion of goodwill. Without the charge, NYSE Euronext would have posted a profit.

The spectacular fall in stock prices in the past year triggers these goodwill-impairment tests. Goodwill is the difference between the price paid for a company in an acquisition -- often lofty in the bull market -- and the value of its assets. That difference is assessed annually and recorded in the company's results, thanks to accounting rule SFAS 142. As the value of the assets declines, companies must write them down and take goodwill-impairment charges. That is bad news for corporate earnings.

"Over the next two months, we will see a substantial number of goodwill impairments, which will be taken as expenses and hit earnings," says James Kaplan, chairman of Los Angeles-based Audit Integrity, which provides accounting-and-governance risk analysis on public companies to auditors, insurers and institutional investors.

Some companies in the news lately for goodwill impairments are Fifth Third Bancorp (FITB), which reported a $965 million charge, part of a $2.2 billion fourth-quarter loss; Regions Financial (RF), with a $6 billion charge; Weyerhaeuser (WY), with charges of $827 million and a fourth-quarter loss of $1.21 billion; Lubrizol (LZ), which had a $325 million charge and fourth-quarter loss of $243 million; and Hartford Financial (HIG), with a $597 million after-tax write-off of goodwill.

Fifth Third shares plunged 29% after the call following the announcement, pushed down by its chief executive's pessimism about the current quarter; Regions Financial fell 24%; and Hartford at one point was off by more than 25% before finishing down about 16%.

Some argue goodwill impairment is a pointless metric, since stock prices anticipate the write-down, and the charge is noncash. But they reduce assets, and such write-downs may prompt trouble with lenders. Last week, Moody's put Weyerhaeuser under review, partly citing goodwill-impairment charges "that may reduce covenant headroom" under two credit facilities. Failure to take write-offs also extended Japan's long decline.

We asked Kaplan's firm, Audit Integrity, to run a screen of companies it believes are likely to report goodwill impairments. The largest 15 by market value are contained in the nearby table and the complete list can be found on our Website, Barrons.com.

Audit Integrity compiled the list by looking for companies where goodwill is at least 15% of total assets and where that ratio is greater than the industry median. Another prerequisite was a ranking of "aggressive" or "very aggressive" on Audit Integrity's proprietary Accounting and Governance Risk rating. That is a quantitative model that weights specific accounting-and-governance metrics from corporate reporting. Aggressive describes risky accounting-and-governance practices.

AMONG THE MEASURES INCLUDED in the proprietary model are rising ratios of the following: accounts receivable over sales; accumulated depreciation over plant, property and equipment; underfunded pension benefits versus liabilities; and cumulative accounting changes. It also flags companies with several amended filings in the past year. Traditionally, Audit Integrity explains, ratios shouldn't change much, and the ratio of receivables to sales, for example, ought to be pretty consistent from quarter to quarter. When they change, it is a red flag -- a sign of potential problems. Those companies with lower AGR ratings, Audit Integrity says, have a greater potential for events like restatements or regulatory actions that are obviously negative for stock prices.

Some of the companies include Procter & Gamble (PG), which bought Gillette for $57 billion in January 2005; serial acquirer ConocoPhillips (COP), created in a 2002 merger, and which in 2006 bought Burlington Resources; biotech giant Amgen (AMGN), which has been buying companies since taking over Immunex in 2002; Monsanto (MON), which bought Delta & Pineland Seeds and Seminis; Kraft (KFT), which bought Group Danone's cookie and cereal division in 2007 and is itself the product of a merger with Nabisco; and CVS Caremark (CVS), which has acquired companies since its 2006 megamerger.

The Bottom Line

We are going to see a jump in corporate goodwill impairments in the next two months. They will hit earnings and, in many cases, stock prices as well.

Mostly, companies declined to comment, without knowing the specifics of the analysis. P&G said it "held itself to the highest standards." Some, like Northrop Grumman and ConocoPhillips, noted they had already announced impairments. And David Rickard, chief financial officer of CVS Caremark, said "This is an excellent illustration of the problems with mechanistic analysis. It points out potential risks that simply don't exist," as CVS has done a "phenomenal" job with its acquisitions.

Kaplan and colleague Jack Zwingli are quantitative analysts and credit experts who oversee the six-year-old Audit Integrity. Among the companies Kaplan is short in his personal account, it ought to be mentioned, are eBay (EBAY) and Transocean (RIG), both on the list.

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