Goodwill - How Good Does It Have To Be?

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Tom Kloos, assistant controller of Thermistics Incorporate, was outlining the requirements for FAS 142, which changed the financial reporting for goodwill. Previously firms had to amortize goodwill over a life not to exceed 40 years. Additionally, each year firms had to determine if the goodwill was permanently impaired and should be written off. The impairment test was an easily one to pass, therefore little goodwill was written off in an impairment charge. FAS 142 changed the goodwill reporting in dropping the required yearly charge for goodwill, but requiring a much more stringent test for impairment. In 2002 firms had to decide to adopt FAS 142 with an initial impairment charge, which would be reported as an accounting change.

Tom favored the initial adoption of FAS 142 with a large impairment charge. The benefits would be: improved earnings quality in deleting most of the goodwill from the balance sheet, higher stock price from higher earnings quality, higher return on equity ratios, and avoiding a later impairment charge shown as an operating item.

Tom's boss, Bill Olet, the controller, could see some pitfalls with a large impairment charge. First, the firm had a loan covenant requiring a debt to equity ratio that could be violated with the impairment charge under FAS 142. Mr. Olet was concerned that the bank would require new performance standards with the violation of the debt covenant. Also Mr. Olet was concerned that certain large investors would question the timing of the goodwill impairment charge under FAS 142. Why did the firm see the impairment in 2002, and not earlier in 2000 or 2001? Does the impairment charge indicate that acquisitions made in the 1990s are not performing to expected levels? And does the impairment charge indicate that future cash flows from acquisitions will be reduced? These are the issues Tom and Bill are debating before they present a unified approach for FAS 142 to the company's board of directors.

This case is intended for use in a financial statements analysis class.

INTRODUCTION

"Lastly, the write off is only an accounting change and has no impact on cash flows." And so ended Tom Kloos' oral presentation to his controller, Bill Olet, about the possible changes to the company's recorded goodwill.

Tom Kloos, CPA, was assistant controller for Thermistics Incorporated, a manufacturer of temperature measuring equipment. Bill Olet, controller, had hired him five years ago, and both appeared to work well together. But frustrations set in when Tom had to explain new, technical changes in accounting and deal with Bill's "questions from left field." Tom had worked for a Big Four accounting firm in earning his CPA. Mr. Olet had an MBA from a prestigious university and had worked for a large consulting firm before assuming the controller's position at Thermistics. Within the accounting/finance department everyone treated Tom as the accounting expert. To those who watched Tom and Bill work together, it appeared that Bill left the technical questions to Tom, but Bill had a broader, top-down view of accounting.

The issue before Thermistics' accounting department is the adoption of FAS 142. This statement changed the reporting for goodwill by eliminating the requirement to yearly amortize the goodwill over a specified life. Once past the initial adoption, the firm would no longer have to amortize goodwill, but the firm would have to do goodwill impairment review each year.

As part of the adoption of FAS 142 in 2002, the firm could write down a substantial amount of goodwill and report the write down as an accounting change. Some security analysts thought that investors and portfolio managers, while concentrating on the operating aspects of the income statement, would disregard an accounting change shown at the bottom of the income statement. FAS 142 requires firms to assess goodwill each year for an impairment, and if an impairment discovered, then goodwill must be written down. In 2002, any write down can be shown as an accounting change; thereafter any write down would be shown as an operating item. The key issue before Thermistics is the write-off of a substantial portion of their goodwill balance.

THE FIRM

Thermistics Incorporated had been founded over 30 years earlier and had carved out a niche business in temperature control and measurement for industrial applications. One family had founded the firm, but by the early 1990s the founding family realized additional capital was needed to expand the business. In 1993 the firm had an initial public offering and raised $17 million of needed capital. A New York investment firm, Heinz & Company, had purchased $3 million of stock in 1993, and the firm maintained an active interest in its investment. The firm had one of the eight seats on the board of directors, and frequently quizzed management on the firm's performance.

Thermistics had been profitable from its inception, but its conservative management depended on internal growth through the 1970s and 1980s. By 1990, Thermistics had accumulated a large cash balance and a strong balance sheet. During the recession in the early 1990s, management realized that the firm could use cash and new infusions of capital to acquire struggling firms in the industry. Beginning in 1992 the firm acquired a score of smaller competitors and spent the remainder of the decade streamlining and consolidating these acquisitions. Purchase accounting was used for all the acquisitions, generating the goodwill balance of over $7 million.

FAS 142

FAS 142 eliminated the requirement to amortize goodwill over a life not to exceed 40 years. In place of the yearly amortization the new FAS required a yearly decision on any impairment to goodwill. To implement the statement a firm must assign or attribute goodwill to specific business segments or reporting units. A reporting unit is an operating segment or one level below the segment level currently analyzed in the segment disclosure. Step 1 of the yearly review requires the firm to compare fair market value of the segment to its carrying or book value. If the fair market value of the unit is greater than the carrying or book value of the unit, then there is no impairment. If the fair market value of the unit is less than the carrying value of the unit, the firm must determine the amount of suspected impairment in step 2.

In step 2 the firm determines the fair market value of all assets and liabilities in the unit without considering goodwill. The total fair market value of the unit is compared to the sum of the fair market values of all non-goodwill assets. The difference is the imputed fair market value of goodwill. This is compared to the book value of goodwill, and the difference of book value less fair market value of goodwill is the impairment charge.

This new statement revises the method of determining impairment of goodwill. An earlier accounting statement used the gross amount of future cash flows to determine the current value of goodwill. The sum of non-discounted cash flows was compared to the book value of goodwill for any impairment charge. With the use of non-discounted cash flows there was rarely a need to take impairment charges. FAS 142 requires a discounted cash flow method or a fair market valuation for goodwill. Fair market valuation could use stock prices and price earnings ratios for competing public companies, or some multiple of an accepted metric, such as a multiple of cash flow or ebitda (earnings before interest, taxes, depreciation, and amortization) for the comparable firm.

TOM'S PROJECT

It was early December 2001 when Tom started his FAS 142 research on how and when Thermistics would implement the new standard. This was the busiest time of the year for him with year-end closing procedures coming due and last minute changes in next year's budget.

He went back to Mr. Olet's work papers for last year's review of the goodwill balance and the evaluation of any required impairment charge.

For the 12/31/00 review Mr. Olet used two approaches- discounted cash flows and market value of a similar business. For the discounted cash flow analysis he used a seven-year horizon and the discount rate of 20%. His analysis estimated the following incremental cash flows attributable to the goodwill balance as of December 31, 2000:

Cash Flows	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
(000)	750	750	1,000	1,000	1,250	1,500	1,500

Next Mr. Olet searched for a publicly traded corporation that closely matched Thermistics' industrial category and product lines. He found a NASD listed firm, which was ten times the size of Thermistics, but matched Thermistics in 65% of product lines. Mr. Olet added the market value of Thermistics' tangible assets, and then compared this sum to the adjusted value of the comparable firm. The difference between the market value of the comparable firm and the sum of the tangible market values would be the market value of any intangible, namely goodwill. Finally, this market value of goodwill was compared to the book value of the goodwill. On December 31, 2000 market value of the goodwill was estimated at $9,000,000.

For 12/31/01 Tom would follow Mr. Olet's examples in determining future cash flows and a comparable market value from a publicly traded firm. He also used a 20% discount rate and used a seven-year horizon. Due to an economic slowdown in the industry, Tom's estimates were reduced from last year:

Cash Flows	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
(000)	700	700	700	750	750	750	1000

Bill used the same NASD listed firm and calculated an estimated market value of $7,500,000.

CHANGE IN MARKET VALUE

	12/31/00	12/31/01
Sum of Cash Flows	$ 7,750,000	$ 5,350,000
Market Value	$ 9,000,000	$ 7,500,000

By the time he presented his findings to Mr. Olet, Tom favored the 2002 adoption of FAS 142 with a write off of $4,500,000 of goodwill. The write down would be shown at the bottom of the income statement as an accounting change for the first quarter of 2002. If the firm decided not to implement FAS 142 in 2002, any future impairment charges would be reported as operating items, and not accounting changes. Early in his presentation, Tom argued that the write off would clean up the balance sheet by reducing goodwill, a difficult asset to value. Investors and portfolio managers would now describe the firm's earnings as of "higher quality," and might place a higher price/earnings multiple on the earnings.
The firm was projecting a 2002 profit of $4 million on $70 million in sales. (See Exhibit 1)

Tom then stated that the return on equity would increase, and this should please the Heinz managers, who focus on return on equity. The return would increase from the smaller denominator of stockholders' equity after the 2002 loss from the write down of the goodwill balance. The only problem was the first year implementation with a reduced net income from the impairment charge.

Tom's concluding argument was the quotation from the opening paragraph. Tom knew that analysts and portfolio managers differentiated income from cash flows. The write off was an accounting adjustment not requiring any cash outflow. Tom was sure some firms would conveniently blame the FASB for requiring this write down, and casually pass off the impairment charge as only "an accounting change."

At the end of his presentation Tom nervously awaited Mr. Olet's questions. Tom had been through this exercise before when it seemed Mr. Olet came up with odd questions and tried to weaken Tom's points. Tom was watching Mr. Olet scribble down notes as the presentation proceeded.

MR. OLET'S RESPONSE

Mr. Olet opened by saying: "I agree with your comment about earnings quality and a cleaner balance sheet from the write-down. But we lose a little in getting there." Tom was surprised with a positive opening comment, and he responded: "How do we lose by adopting FAS 142?"

"One problem is our debt covenants with the Security National notes. The covenant limits us to a long-term debt to equity of 1.5, which we barely meet now. I am afraid if we write off $4.5 million we will violate that covenant. In normal times we would not have too much difficulty in getting the bank to give us a one-year waiver on the covenant. But Security National has had a poor year in this recession and had to absorb some bad debt write offs. The lending officers might use our covenant violation to squeeze more concessions out of us.

"I am also concerned about the Heinz representative. That firm takes a very active interest in our reports and operations. Remember they own over 10% of the outstanding stock. I can see Heinz asking us why did we see this impairment in 2002. Didn't we see any impairment in 2000 or 2001? Are our reports from prior years inaccurate? They could even consider a lawsuit over improper reporting.

"Also your final comment on write-offs versus cash flows. On the surface your comment is correct for the write off adjustment that would show up in the income statement. But remember how we are required to determine any impairment in the reported goodwill. We have to review each of our divisions and determine future cash flows from those specified operations. The act of reporting an impairment suggests that future cash flows from one or several operating units would not measure up to expectations or past performance. Are cash flows expected to be less going forward? Did we pay too much for the acquisitions in the past, and we now have to write off some of that excess? Are these acquisitions not working out? These are questions I can see the Heinz representative raising."

Tom realized that he had concentrated on the purely mechanical aspects of this accounting adjustment. In all fairness his job did not involve banking relations or relations with the Heinz interests. Tom shuffled his notes struggling to find a quick solution to Mr. Olet's problems with FAS 142.

EXHIBIT 1

Thermistics Incorporated
Projected Income Statement and Balance Sheet
December 31, 2002 (000)

Income Statement	
Sales	$ 70,000
Cost of Goods Sold	40,000
Gross Profit	$ 30,000
Selling Expense	13,000
General & Adm. Expense	10,000
Pre Tax Income	$ 7,000
Tax Expense	3,000
Net Income	$ 4,000
Balance Sheet	
Assets	
Current Assets	$ 22,000
Long Term Investments	5,000
Property & Equipment	40,000
Intangibles	8,000
Total Assets	$ 75,000
Liabilities	
Current Liabilities	$ 15,000
Long Term Debt	36,000
Total Liabilities	$ 51,000
Equity	
Stockholders' Equity	24,000
Total Liabilities and Equity	$ 75,000