



Intangible assets

Beware goodwill, the frothy excess of what a company pays for an acquisition beyond its fair value

There's a lot of goodwill in the market these days. I'm not talking about the warm, fuzzy feeling you get when you look at your portfolio stuffed with commodity stocks. Rather, I'm speaking of that ever-bloating line on the balance sheets of some companies called goodwill.

What is it? And should you be alarmed when it accounts for 50% to 75% of a company's assets? To be frank, goodwill offers an easy opportunity for management to fake the earnings power of a company. So, the more you know about it, the better.

To start, goodwill is the frothy excess of what a company pays for an acquisition on top of the fair value of the net identifiable assets. For example, Yellow Pages Income Fund (TSX: YLO.UN) paid \$2.6 billion last year for ADS (Telus' old phone-book business). After Yellow Pages placed a fair value on everything it acquired, from furniture to trademarks, the excess (or goodwill) left over was \$2 billion. This amount got plunked on the balance sheet where, along with previous goodwill acquired, it now accounts for 72% of the company's assets.

Obviously, goodwill must represent something for Yellow Pages to have paid \$5.3 billion for it as of the end of last year. Call it synergy, or whatever you want. In the end, it should produce enough cash flow to justify its price. And this is where you need to have a very good sense of the risks involved.

It used to be that companies regularly amortized their goodwill, drawing down the amount every year and recognizing an expense on the income statement. It made sense that since the goodwill was helping to produce revenue, it should be matched up as an expense as it slowly deteriorated. And yes, most goodwill eventually deteriorates to nothing.

So, will phone books be as popular 50 years from now, or should Yellow Pages slowly recognize an expense for its deteriorating assets? Expensing the goodwill over the next 50 years would cut current income by 44%. I think it's fair to ask whether, come 2056, we'll still be looking up phone numbers in printed books that cover increasingly smaller geographic areas.

The counter-argument, and management presumption given the current accounting, must be that Yellow Pages' websites will



increase in value so much that they will offset the decline in the printed directories business. Thus, the goodwill will eventually have to represent an Internet domain that searches online information. (Yeah right, no competition there. See www.local.google.com.)

I don't mean to pick on Yellow Pages. There are plenty of firms with the majority of their assets in goodwill: Davis + Henderson Income Fund (85%), Custom Direct Income Fund (85%), Osprey Media Income Fund (68%), Westshore Terminals Income Fund (63%), Liquor Stores Income Fund (59%), Gienow Windows & Doors Income Fund (57%) and IBI Income Fund (56%). Noticing a theme yet?

Now that companies no longer regularly expense goodwill, they are supposed to assess the fair value every year to determine whether a writedown in value should be expensed on the income statement. Usually, the value is determined by an approach set forth by management, or a friendly consultant.

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Thus, there are many ways to delay the recognition of such expenses, including optimistic assumptions of future growth, or lumping impaired assets with undervalued assets. Indeed, most companies don't bother to recognize such expenses anymore, and if they do, investors tend to ignore the writeoffs as past mistakes rather than as regular expenses of the business.

Investors should look to minimize risk by seeking detailed explanations of the methods and assumptions used by management to value the goodwill of each operating segment. Some firms provide pages of details, while others, like Yellow Pages, provide nothing more than boilerplate throwaway disclosures. You need to ask: do you want to risk tying up 75% of your investment in something that management can't be bothered to explain? ☐

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