

COMMENT

Playing games with goodwill

Potential for evil exists because of vague rules

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I was recently reminded yet again of just how easy it is to play financial reporting games in Canada. As a forensic accountant I regularly get to examine accounting shenanigans from

an insider's perspective. I witness first-hand the failures of the auditors to catch the chicanery, and how investors are misled about the profitability of public companies.

Investment failures can result from many factors: vague and loose accounting and auditing rules, poor auditor training, and a general lack of accountability in the self-regulated accounting profession. These problems aren't about to get any better, and in many respects, they're getting worse.

Take for example, the issue I came across again — the financial reporting choices that exist when it comes to accounting for corporate acquisitions. If ever there was fertile ground for accounting games, it's among companies that acquire others on a regular basis.

Naturally, not all companies that acquire others have skeletons hiding in the closet. In fact, Canadian home-improvement and gardening retailer Rona Inc. is a company that has grown quite successfully

through corporate acquisitions. We recommended Rona to our institutional clients this past March and the company still represents good value in our opinion.

Nevertheless, in terms of accounting for acquisitions, the potential for evil exists because of the utter vagueness of the accounting requirements. When a corporate entity is purchased by another, the acquirer is supposed to fair value the assets and liabilities of the company it acquires. In other words, the

assets and liabilities are recorded on the acquiring company's balance sheet at their supposed fair values. I say "supposed" fair values because they might be anything but.

Once the net "fair" value of the assets is determined, any extra amount that was paid for the company is then plopped down as goodwill (an asset) on the balance sheet. The slipperiness comes into play when the total acquisition price is essentially divvied up among the net assets (including goodwill).

The potential exists (and believe me, it happens) for certain assets to be undervalued and others to be overvalued. It's as easy as tipping water from one glass to another. However, the impact on reported income in future periods can be all the difference in the world.

An asset that can easily turn into cash the next period (such as a batch of accounts receivable) might be recorded at a reduced fair value upon acquisition. The spurious reasoning could be management claims of diminished collectability. Once the cash is received, and then some (because the receivables were intentionally undervalued), the extra amount becomes income that otherwise should not have existed.

The same can be done by undervaluing inventory. Once sold, the profit margin after the acquisition is higher than it should have been. Investors are impressed and they bid the shares higher. Management can then use the inflated share price as currency to make further acquisitions and play the same game over again.

The trick I saw recently was a company that acquired an entity that had launched a successful lawsuit against a third party. At the time of acquisition, the acquiring company assigned no value to the money to be received. When the proceeds were subsequently paid, the cash was treated as income instead of simply the settlement of a receivable.

The only side effect of undervaluing certain assets is that goodwill must then be overvalued so that the asset figures balance out. For executives who are trying to goose profits in the short term for higher bonuses, a bloated goodwill figure is of little concern.

For the past five years now, accounting rules require goodwill to stagnate on the balance sheet until management and/or the company's paid auditors decide that the amount needs to be written down to a lower amount. The ensuing expenses

THE BEST ADVICE IS TO LOOK FOR UNEXPECTED SPIKES

are quickly ignored by most investors as one-time or non-cash in nature (both those descriptors are moot, by the way, but not the point of this article).

If even those sporadic charges for impaired goodwill are too much to face, management has options at its disposal. Thanks again to the loose accounting rules, impaired goodwill can be matched up with assets recorded at low historical costs, and management can claim the combined amounts are still fairly valued. In short, the potential for gamesmanship seems endless when it comes to the financial reporting of acquisitions.

I've been writing these articles for the past decade not because I expect the accounting profession will be shamed into cleaning up its act. Rather, this column is meant to educate investors of all ilk, and whenever possible, to propose ideas that they can use to better their investment process. However, the topic of corporate acquisitions is an issue so nebulous, it defies easy answers.

I don't imagine many investors are willing to delve so deeply into the accounting statements as to start tracking individual assets and liabilities. The best advice, then, is to look for irregular or unexpected spikes in income or profit margins after acquisitions have been made. Likewise, ballooning goodwill figures should be monitored to determine if other more tangible assets are being used to prop up the phony values.

Sometimes, it's simply a matter of gut feeling. If the reasons for certain acquisitions seem sketchy, the benefits seem unclear or speculative, the values of intangible assets seem unsupported, or the company evades your queries, it might be time to find more comfortable investments.

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