

Mergers' 'goodwill' gone bad can sour the books

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San Mateo, Calif. - Two giants of the new economy, AOL Time Warner and Broadcom Corp., hit the headlines in recent weeks with enormous quarterly financial losses. Broadcom reported an astonishing \$1.768 billion loss for a single quarter, and AOL eclipsed the chip maker's news with a \$45 billion write-off.

Analysts and corporate financial managers say there probably are more huge write-offs coming, but they may not spell gloom and doom for the electronics industry as a whole or even, necessarily, for the individual companies. The reasons are buried in the source of the write-offs: a relatively obscure change in policy by the Financial Accounting Standards Board announced in the middle of 2001.

The heart of the issue is goodwill-not the warm-and-fuzzy feeling or the charitable organization, but the technical term used in financial accounting. And the key concept involves acquisitions.

When one company acquires another and merges it into its own operations, the assets of the acquired firm go onto the books of the buyer. These assets include tangible things, such as real estate and undepreciated equipment, and intangible but identifiable things, such as patents, trade secrets, contracts with key employees and the like. You can't touch them, but you can estimate their value.

If you add up all the assets and subtract them from the purchase price of the acquired company, there is usually something left over. During the bubble economy, it was often something enormous. This represents the premium the acquirer paid for the company it bought over the value of the assets. That difference gets recorded on the acquirer's balance sheet as "goodwill."

Traditionally, the acquiring company amortized the goodwill over some reasonable period-anywhere from a few years, if the company were in a rapidly shifting technology business, to 20 years in very stable markets. That amortized goodwill showed up each quarter as a noncash expense on the income statement.

But in 2001, the FASB decided this practice was distorting reported numbers, in both positive and negative ways. In Statement 142, the board decreed that from now on, some of the goodwill from acquisitions-namely, those intangible assets that aren't associated with any specific thing such as a patent, a trademark or an employment contract-would have to be treated differently. On the other hand, those intangible assets that could be identified would continue to be amortized.

Starting, in most cases, with the accounting year beginning after Dec. 15, 2001, the goodwill from acquisitions would have to be tested every year to see, in effect, if the

value was still there. If it was not-in the FASB's terms, if it had been "impaired"-then the company would have to report that impairment as an expense in that year. The first accounting years affected by the ruling are just ending. And at Broadcom and AOL, the enormous losses were not the result of actual cash going anywhere, but of huge impairments to goodwill from acquisitions.

Clearly, the impact of the ruling depends on a number of things. If a company hasn't made any acquisitions, it is unaffected. If, as one investor said of Cisco Systems, "their R&D policy was acquisition," there could be a substantial effect. But not necessarily.

The key issue is the test for impairment. "The process is getting to be fairly mechanical by now," said Bill Porter, chief financial officer at Cadence Design Systems Inc. Robert Promm, Cadence's corporate controller, added, "It's a fairly rigorous business-school kind of process, and it comes under a great deal of scrutiny."

There are two tests, said Promm. First, the company does a discounted cash flow analysis. That is, it estimates the portion of expected revenue, minus expected expenses, that will occur in the part of the organization that absorbed the acquired business. "You have to look one level below what FASB calls the segment level of your business," Promm explained. That might be a product line, a business unit or some similar level. Then you estimate how much of that cash flow is due to the goodwill. That gives a rough picture of the value remaining in the goodwill.

As a reality check, there is a second test, based on the "willing-buyer" concept. Simply stated, what portion of the market capitalization of the company is based on this goodwill? Or, alternatively, how much would the product group be worth if it were spun off today, and what portion of that value is in the goodwill? The results of the discounted-cash-flow and willing-buyer analyses are combined, by averaging or by some other reasonable means.

Comparing Broadcom's results with Cadence's is instructive. In Broadcom's case, the analysis determined that much of the value of the goodwill accumulated by the acquisition of a string of fabless semiconductor companies, all serving the networking and communications markets, had been impaired. The company decided to write off \$1.241 billion as impairment for the year-about half the goodwill on its balance sheet. In comparison, Cadence's balance sheet shows goodwill of approximately \$200 million. In its most recent test, the company found no impairment at all.

To pinpoint the difference, look at the second test, the willing buyer. The market values of fabless chip companies in the networking market-and any reasonable projection of their future revenues-has plummeted. "A big drop in market capitalization is a big red flag for impairment." said William Quigley, managing director at Clearstone Venture Partners. In the EDA industry, however, company valuations haven't really changed that much since the bubble days. It is entirely plausible that a hot EDA company is worth about as much now as it was a year ago. So the impact on the income statements is justifiably different.

Consider a third case: Cisco Systems Inc. Cisco currently shows \$3.7 billion in goodwill on its balance sheet. And last week it reported quarterly results showing no impairment. Here, timing is everything. Cisco's fiscal year ends in July, not December. It reported no impairment in July 2002, based on market conditions at that time. The company will not have to report the results of any impairment tests for 2003 until the end of July.

Intel Corp., another company with a big taste for acquisitions, reported in its Q4 statement \$4.3 billion in goodwill on the books and approximately \$100 million in combined amortization and impairment, according to a company spokesman.

'Almost nothing'

So the impact on reported income will vary widely based on the kind of business acquired, and how such businesses are faring in the market. What do the numbers mean for operations?

"Almost nothing," Quigley said. The huge charges do not represent an actual cash flow, and hence don't indicate any change in a company's ability to conduct business or write checks. The primary effect is psychological. By making a huge write-off, the company is admitting to very bad taste in acquisitions, or at least very poor skills at long-term valuation.

One secondary effect bears watching, however, particularly for companies with modest market capitalization and heavy debt loads. Often, loans or lines of credit contain rules-covenants, to be precise-that specify a certain level of tangible net worth. If a huge write-off reduces shareholders' equity (the difference between total assets and total liabilities) below the threshold specified in a covenant, a lender may call a loan. Such an event can usually be negotiated, particularly if the company doesn't take the lender by surprise, Quigley said. But in a delicate situation it could trigger a serious financial scramble.