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Underwriters of D & O and Professional Liability Insurance

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In this issue . . . **we look at a recent change in corporate accounting rules.**

Goodwill: Let the Games Begin

Introduction

Thanks to the historic collapse of Enron, the accounting profession has been submitted to the unaccustomed attention of the news media, politicians and financial pundits. We noted in our December newsletter the chief of Andersen humbly suggested a change in the accounting profession might be due. That was before his company was found to have shredded many documents relating to their audit of Enron. What many see as a smoking gun showing Andersen's culpability has ratcheted up the stakes: Andersen is now battling to save its clients and maybe even the company.

As the accounting industry alternately basks and squirms in the glare of its temporary notoriety, accounting reliability has become a widespread concern and its importance for D&O liability reemphasized. In this issue we look at one particular accounting topic of current interest, Federal Accounting Standards Board Statement No. 142 ['FASB 142']

Goodwill: The Old Rules

When one company purchases another, goodwill is the portion of the purchase price that's greater than the book value of the assets purchased. This amount can run pretty high: when AOL bought Time-Warner, a massive $190 billion was assigned to goodwill and other intangibles.

Prior to FASB 142, even though AOL owned the goodwill it had acquired and therefore could view it as an asset, for accounting purposes AOL had to expense the cost of the goodwill in equal, annual installments, a process known as amortization. In AOL's case this meant that every year for 25 years, $7.6 billion would be charged to their earnings.

Say Goodbye to Amortization

Under the new rules of FASB 142 that became law on December 15, 2001, goodwill is no longer to be amortized in equal, annual amounts until it has disappeared. Instead, goodwill is kept off the income statement and hidden in the 'company closet,' only to emerge at such time it is deemed to have been 'impaired.' This assessment of impairment is to be made every year, and if impairment is judged to have taken place an appropriate charge will then be taken. Under the old rules, write-downs of goodwill were also required if the goodwill had been impaired, but there was not the annual review stipulation that FASB 142 introduces.

Possible Implications?

1) Because there will be no more automatic amortization expense attached to goodwill, during this first year of FASB 142 a company's earnings per share [EPS] could see a boost in comparison to the prior year. This will in turn produce a lower price / earnings ratio. Combined with a jump in the EPS this could make a company's stock appear to be an attractive deal, and spur investor buying.

2) Companies could make use of the new 'impairment' option and purge the goodwill from their books. This one-time charge, while looking horrible, is often viewed by Wall Street as a healthy exercise in corporate house cleaning and often does not damage the stock price. The fact that companies do not have to take a direct hit to their operating earnings the first time they do this may prompt some early, aggressive write downs.

3) Companies making acquisitions may be tempted to over-value goodwill within the total purchase price because amortization would no longer drag down their earnings for years to come. This will have the added benefit of under-valuing other assets that can be liquidated later at an apparent premium, also helping earnings.

4) A significant amount of goodwill on a company's balance sheet will create opportunity for manipulation by management. Will this intangible asset be properly valued each year? FASB 142 provides a methodology for testing impairment but some scope for subjective interpretation remains.

Conclusion

A company's new discretion in determining the timing and amount of goodwill impairment may increase the ability to 'manage earnings.' In addition, if companies elect not to trumpet FASB 142 as a major reason for a jump in earnings, year-to-year comparisons may be more difficult. Footnotes in financial reporting will become more important than ever. For analysts, investors and D&O underwriters, this first year of FASB 142 could pose some challenges.

Notwithstanding these possibilities, FASB 142 is still just an accounting rule that will not make a business any better or more profitable but might give that appearance. Cash flow and revenues remain key indicators of a company's financial health: $1 billion of goodwill will not buy you a cup of coffee. The best investment professionals already ignore amortized goodwill expenses and will also ignore misleading earning jumps in their assessment of corporate health, but many less sophisticated investors and commentators may not read beyond the headlines of the press release. It is impossible to predict what will be the effect on D&O liability, but it is certainly something to be watched: a large amount of goodwill on a corporate balance sheet could prompt some additional questions from our underwriters. ✍

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