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IFRS Spells Write-Downs as Goodwill Withers Away

By NATHALIE BOSCHAT

PARIS -- As the recession bites and stocks continue to slide, acquisitions made by European companies at the height of the merger boom could become a time bomb, as accounting rules are likely to force some businesses into heavy write-downs on goodwill when they report 2008 earnings.

International Financial Reporting Standards have been used by most countries since 2005, but this year marks the first time they will be implemented against the backdrop of a sharp economic slowdown and a heavy stock-market selloff, accountants and experts say, warning that companies could take a severe hit as a result.

As global markets continue to fall, European companies are worrying about the impact on the fair value of assets acquired at high prices during the mergers-and-acquisitions boom of the past four years, said Marc Gerretsen, partner at accounting firm PricewaterhouseCoopers in Paris. "It's the first time those rules will be tested in a bear market," Mr. Gerretsen said.

The sharp deterioration of economic conditions, with the euro zone slipping into recession in the third quarter, will also prompt companies to take a hard look at the value of assets they bought recently, since the slowdown will likely constrain their ability to generate cash -- another parameter used to calculate value.

Mr. Gerretsen said he is talking to clients about how to grapple with the problem, although "we're not yet at the stage where we are putting figures on potential goodwill impairments," he said.

The stakes are high. In Europe, the total amount of goodwill for companies included in the Dow Jones Stoxx 600 index is about €1 trillion ($1.26 trillion), according to the latest data disclosed by companies. This compares with a total market capitalization of €3.507 trillion for the index as of Friday's close, down 50% since the start of the year.

Hefty write-downs could be more than just an accounting adjustment. With write-downs cutting into equity, companies' leverage ratios would increase. That could harm companies' ability to borrow for investment and growth, at a time when financial turmoil has already made banks less willing to lend.

"We will see how the IFRS rules on goodwill impairment are applied in the current stock-market reversal. The results could be ugly," translating into heavy losses for shareholders, warned Nicolas Véron, an economist at Brussels-based think tank Bruegel.

Goodwill shows up on a company's books when it makes an acquisition for which it has paid more than the book value of the target's assets. The excess paid -- minus certain adjustments -- is defined as goodwill and is added to the acquiring company's balance sheet as an asset.

In France alone, the total amount of goodwill for companies included in the SBF 120 stock-market index reached €350 billion at the end of June, as companies have spent heavily on acquisitions over the past few years. The overall goodwill for SBF 120-listed companies compares with a total market capitalization of €841.5 billion for that index at Friday's close. Since the start of the year, the index has lost 49%.

Topping the list of companies with high goodwill are telecommunications giant France Télécom SA, drug maker Sanofi-Aventis SA and telecommunications and entertainment conglomerate Vivendi SA. France Telecom's goodwill at the end of the first half was €31.6 billion, while Sanofi's and Vivendi's were €26.4 billion and €20 billion, respectively. Accountants caution that companies with the highest goodwill won't necessarily incur the biggest write-downs.

Under IFRS rules, companies have to carry out goodwill-impairment tests annually to determine whether the value of what they have acquired needs to be written down, either because of a drop in fair value linked to market prices, or because their ability to generate cash flow has decreased. These tests can take place more than once a year if "major events point to loss of value," Mr. Gerretsen said.

This is a major departure from previous French accounting rules, under which goodwill was amortized on a linear basis every year. Under that system, a portion of goodwill was written down every year by a set amount over a defined period, until it eventually dropped to zero in the company's books, making the depreciation process relatively painless.

"At the end of this year, it's going to be hard for companies to ignore several months of plummeting stock prices. Under IFRS rules, the pressure for companies to write down the value of assets acquired through business combinations doesn't diminish over time," said Yann Magnan, managing director at Duff & Phelps, a U.S.-based independent valuation-advising firm.

Assessing whether and to what extent goodwill needs to be written down is crucial for companies, as the decision, once made, is irreversible. This has far-reaching consequences because goodwill impairments eat directly into the companies' equity.

"The sharp fall in stock markets could have a real impact via mark-to-market accounting methods which force companies and pension funds to book unrealized losses, which they then have to make up for by selling assets or cutting back on investment spending," said Keith Wade, chief economist at London-based asset-management company Schroders PLC.

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