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**Commentary**  
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## **New Accounting Rule Could Roil the Markets**

FAS 142 changes the way companies account for goodwill and investors MUST be aware of the potential earnings impact for two main reasons, both of which could give uninformed investors a wrong signal:

1. The change will generate a one-time boost to EPS that could fool the market into thinking it represents a change in the fundamentals and
2. Goodwill charge-offs could occur during the next few quarters, which will further depress weak earnings.

FAS 142 is the new accounting rule that changes the way companies account for goodwill. Previously, companies were required to amortize goodwill and this non-cash expense reduced reported (GAAP) EPS. FAS 142 eliminates amortization and instituted an annual impairment test. This article will briefly review the potential impact of these changes on reported earnings. We expect the changes to start impacting earnings by the end of this year.

### EPS Impact: A Potential False Positive

The first risk is that the accounting change will provide a one-time boost to a company's EPS which may be misinterpreted by the market as an improvement in the long term earnings potential of the company, causing the market to move the stock higher. There is also the possibility that the market may react like it does when a company announces a stock split, bidding the shares higher although there is no change in the fundamental earning power of the company.

However, in reality, a company's fundamentals, real earnings potential, and cash flows remain unchanged despite the new rules. *FAS 142 can be viewed as a rule change that is occurring in the middle of the game.* But because companies are not required to restate historical results, the change will potentially result in significant EPS growth in the first quarter after adoption of the rule. During the next three quarters, while EPS growth will be exaggerated when comparing to the same quarter in the prior year, sequential EPS growth will fall back to lower ("normal") levels.

After the dismal earnings reported in this year, this sudden acceleration of EPS growth may generate a knee-jerk reaction in the market, causing these shares to rise. Under this scenario, uninformed investors may get caught up in the excitement and could lose money as they chase what they think is strong earnings growth.

Ironically, the companies that may experience the greatest EPS "growth" from this change are the old dotcom darlings. Internet and telco companies whose earnings have evaporated (did they ever exist?) could post significant EPS growth as they eliminate the amortization of the huge amounts of goodwill they accumulated during the heady times when all-stock mergers

were done at outrageous multiples. Hopefully, these companies will resist the temptation to use this as an opportunity to generate renewed interest in their tired shares. (Not!)

### **Impairment Hell: Another Blow to Already Weak Earnings**

The second risk is the one-time charge-offs that may be forthcoming during the next two quarters, will further depress already weak earnings. FAS 142 requires companies to annually evaluate goodwill in light of expected value (an impairment test) and charge off goodwill if it is impaired (i.e. the appraised value is less than the value recorded on the books).

Companies have a year after adoption of FAS 142 to perform the impairment test and charge off impaired goodwill, but the rule provides incentives to bite the bullet during the first fiscal quarter after adoption. For example:

- If the charge is made in the company's first fiscal quarter, no restatement is required and the charge is treated as an extraordinary item (does not impact net income because it is recorded below the net income line).
- Charge-offs made after the first quarter of the fiscal year will require restatement of preceding financial statements.
- Charges made after the first year will be treated as operating expenses and will reduce net income.

Consequently, it behooves a company to bite the bullet and take the charge in their first quarter in order to avoid a hit to earnings and the cost of restatements.

Another factor that could accelerate impairment charge-offs is that current market valuations are significantly below the prices paid for the acquisitions a few years ago. The opportunity to "clean house" at the start of the New Year, as well as complying with the new rules, could result in very large charge-offs.

A current example of this impairment risk is Enron. In its 10Q filing on 11/19/01, Enron disclosed that it "might be forced" to take a \$700 million pre-tax charge to earnings...due to a drop in the value of some of its assets" (Quote taken from article in The Wall Street Journal. November 21, 2001, page A4). While FAS 142 is not specifically cited as the sole reason for the write-off, and we have not been able to contact management for a clarification, this does sound like an impairment "event".

How the market will react to this additional bad news is unknown, but we see two possible outcomes. On one hand, the combination of dismal economic data, weak earnings and FAS 142 charge-offs could combine in a grand sell-off as investors perform their year-end tax selling. On the other hand, the news that companies are cleaning house may provide some good news for bulls in a very bearish market.

### The Impact of FAS 142 should be felt During the Next Earnings Season

The impact of FAS 142 should be revealed as companies report year-end results next spring. While most of the larger companies have fiscal years that are calendar years, there are a number of companies with non-calendar fiscal years that will report FAS 142 results later this year and early 2002. This should provide a good indication of how FAS 142 will impact results and how the market will react.

## The Bottom Line

Caveat Investor! Artificially inflated earnings growth and large asset charge-offs could negate each other as well as they could cause stock volatility. In any event, investors will need to dig even deeper into financial statements in order to fully understand a stock's long term earning potential and not be fooled by an inefficient market and companies willing to do whatever it takes to generate spin for their shares.

Other sources of information:

[www.cfo.com](http://www.cfo.com)

[www.accountingweb.com](http://www.accountingweb.com)

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