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Corporate Canada's Battered Goodwill

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If you're a fan of goodwill impairments (and I mean, really, who isn't?), then you've had a lot of fun in the past few years.

First, we had a deep recession and a financial crisis. Then just as we were recovering from that, we had the adoption in Canada of International Financial Reporting Standards (IFRS), a set of accounting standards that is in many ways tougher on goodwill than the old made-in-Canada rules.

The result? Canadian corporations booked a massive $34-billion in goodwill impairment writedowns from 2008 to 2011, according to a new study to be released this week by the Canadian Financial Executives Research Foundation and financial advisory firm Duff & Phelps. (The Globe and Mail received an advance copy of the report.)

While the credit-crisis year of 2008 featured a whopping $10.4-billion in writedowns, the report says, the adoption of IFRS delivered an even bigger wallop: A combined $19.4-billion in 2010 and 2011, including $11-billion in 2011 alone.

Goodwill is, essentially, the value carried on a company's books to represent the gap between what a company paid for an acquisition, and what it could reasonably expect to fetch for the physical assets of that acquisition if it were to sell them off. Typically, it reflects the premium over book value that a company paid for an acquisition, on the belief that the money-making potential of the assets exceeds the sum of its physical parts. Eventually, if it becomes clear that the potential for the assets no longer justify the value on the books, prudent accounting practices dictate that the company has to reduce the value – that's an impairment writedown.

"Prior to IFRS … you could have one part of the business doing extremely well that would shield the potential goodwill impairment of another part of the business. Now you can't do that," Michael Staresinic, vice-president at Sprott Inc., is quoted in the report. "In any given year, if one part of the business underperforms, you could have a goodwill impairment when every other part of the business is strikingly handsome."

But while that assessment, together with the unsightly writedown numbers, may reasonably strike fear in any right-minded investor, the study suggests IFRS may not necessarily mean we're in for elevated goodwill writedowns from now on. Only 17 per cent of public-company financial executives surveyed in the study indicated that IFRS adoption was the main cause of their goodwill writedowns.

The study found that S&P/TSX composite stocks that booked goodwill impairments in the 2007-11 period did substantially underperform both the overall market and companies that didn't book any such charges; returns for the impairment-booking stocks were 21 per cent below the non-impairment stocks.

However, a separate study of among S&P 500 stocks, conducted by Duff & Phelps and the U.S. arm of Financial Executives International, found that stocks of companies that took goodwill writedowns suffered their biggest underperformance in the year *before* the writedown takes place – indicating that the market is aware of problems in those companies' business conditions and anticipate the risk of a writedown. In the year after the writedown is booked, these stocks still underperformed the market, but the gap was a relatively modest 1 percentage point, and the underperformance shrank over time.

David Parkinson is a contributor to ROB Insight, the business commentary service available to Globe Unlimited subscribers.