



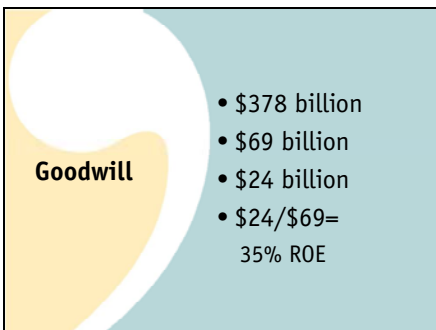
I thought goodwill might be an interesting topic to give an introduction to. It is something people sometimes point out as a concern about certain companies and it is something that is related to recent concerns about whether data feeds some of you are using to make judgments with are raw accounting data or they have been massaged or “normalized”. In addition, with the current market downturn it is especially important to understand how goodwill might increase the vulnerability of some of your investments to price degradation.



I’m sure you’re all familiar with this company.



And probably with this person. Steve Jobs adds value to Apple. The fact that you know the company when I show you a logo and the person when I just show you a picture gives you some idea of the value that that asset has. But it’s not an asset you’re going to find anywhere on Apples balance sheet. We call it Goodwill.



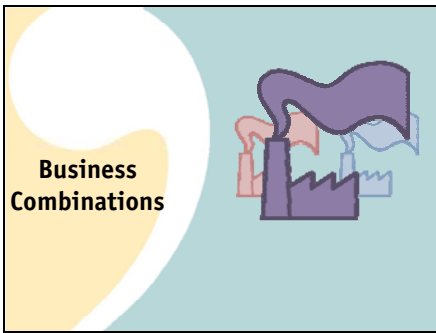
The current market value of all the outstanding shares of Apple stock is approximately 378 billion dollars.

The current book value of Apple is approximately 69 billion dollars. Some of the reason for the difference between these two numbers is the goodwill that comes from investors being excited that Steve Jobs is running this business.

Over the past 4 quarters Apple had earnings of approximately \$24 billion dollars.

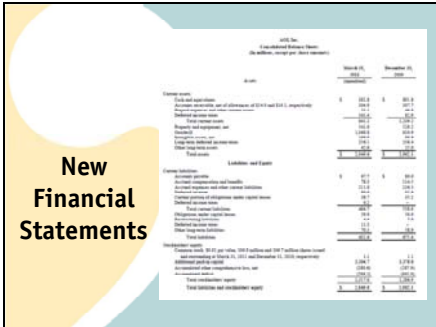
This meant they were producing a very nice Return on Equity for their investors

of approximately 35%

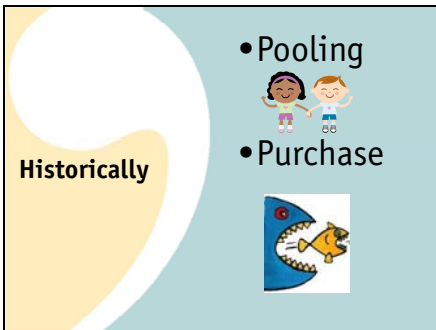


Some see goodwill as representing the competitive advantage a company has. This is what will allow it to generate earnings which are greater than a “normal” return on its assets. Goodwill developed internally will not show up anywhere on a company balance sheet.

It only becomes an asset on a balance sheet when a company is acquired by another company.



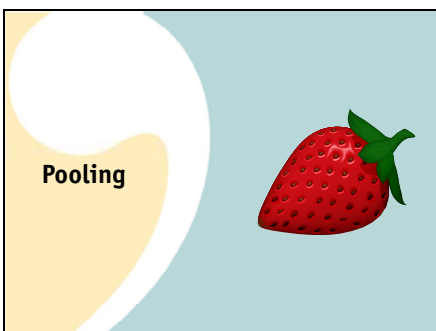
This is because when businesses combine, their financial information must be combined to represent the economic status of the new business.



Historically, there have been two methods of combining information.

Pooling in which shares of one company is exchanged for shares of another and everything on the two companies’ balance sheets is combined at the current carrying value.

And purchase methods where one company is identified as the acquiring company and has to add the assets it has purchased to its balance sheet at their current fair values.



To give you an idea of what it means to you as an investor, here is an example.

Suppose I ran a company named Strawberry. Suppose I also had 24 billion dollars in earnings and a market cap of \$378 billion and a book value of 69 billion, just like Apple. Suppose I thought it would be a good strategic move for my business to combine with Apple.

So I offer Steve and all the Apple stockholders, one share of my company for every one share of theirs and they accept

**Pooling**



Earnings  
 $\$24 + \$24 = \$48$

Equity  
 $\$69 + \$69 = \$138$

ROE  
 $\$48 / \$138 = 35\%$

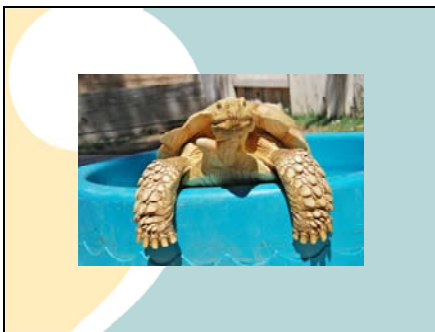
I will now have the fruit salad company. Under the pooling method, I will have

48 billion dollars of earnings and

\$138 billion dollars of equity.

My investors will be happy. I will have doubled my earnings and my Return on Equity will remain at 35%.

That used to be a way businesses could account for acquisitions. Despite strict rules trying to limit its use, most businesses tried to set up their acquisitions like this so they could take advantage of having the increased earnings without the burden of the true cost they had taken on to generate them.



While company managers really liked pooling, it is no longer allowed.

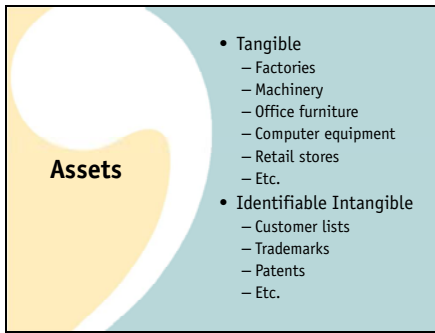
**Purchase**

- +\$378 billion
- Total equity  
 $= \$378 + \$69$   
 $= \$447 \text{ billion}$

The rules changed in 2001. Now all acquisitions need to be recorded as purchases. Using that method,

It's going to cost me \$378 billion to acquire Apple.

I'm going to combine that with my current equity and end up showing \$447 billion dollars of stockholder equity on my new balance sheet.



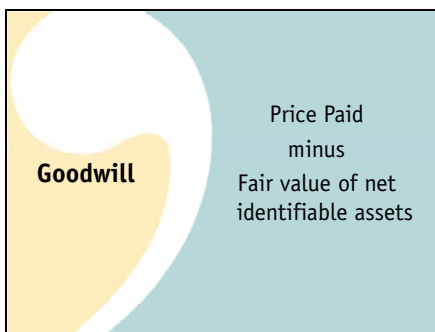
This will come from adding all the Apple assets to my balance sheet at their fair values.

This includes tangible assets like :

- Factories
- Machinery
- Office furniture
- Computer equipment
- Retail Stores
- Etc,

And what are called Identifiable Intangible assets like:

- Customer lists
- Trademarks
- Patents
- Etc.



I will also have to add a new asset called Goodwill. This will be the difference between

what I paid to acquire the new company

And the fair value of everything identifiable that I purchased such as the things I listed on the last slide. The thing to remember is that Goodwill isn't something you can identify separately; it's what we call a residual. It's the amount left over after things you can identify and value are subtracted.

**Purchase**

Earnings  
 $\$24 + \$24 = \$48$

ROE  
 $\$48 / \$447 = 10.7\%$

So now my ROE calculations will look like this.

If I still earn \$24 billion dollars a year on the Apple side of my business, my combined businesses will earn \$48 billion dollars.

But now I'm measuring that against my entire investment. The book value of my equity is much higher and

My return on equity will have changed from 35% to 10.7%. Unless there are beneficial synergies from our combination, right off the bat, I will not be able to run Apples business as profitably as Apple did.

**Purchase**

- Increased expenses
  - Amortization
  - Depreciation


I might not even be able to produce the level of earnings Apple had when they ran the business because I'd

probably have increased expenses.

My amortization and

depreciation costs might be higher because I had to mark up the values of all the assets I had purchased to current market value when I combined the companies.

**Purchase**




Recording acquisitions in this manner allows you, as my investors to easily see whether I've made a wise investment which is going to result in a good return to you.

That is why the pooling method was disallowed and only the purchase method can be used now.

**Earnings Impact**

- Annual Impairment Test



Goodwill is not depreciated or amortized gradually as an expense like other assets.

Instead, it is “tested” annually to determine if it has become less valued. We call this testing for impairment. If it is determined that it has lost value, the write down is charged as an expense. Impairment charges usually have a big impact on earnings.

But they tell us something and should not be dismissed as unimportant. If goodwill needs to be written down, it’s because management has made an investment which is not providing the expected results.

In essence, they have thrown some of our equity out the window

**Earnings Impact**



We, as investors, make judgments and predictions about future stock prices using our projections about future earnings. A potential for future earnings to be lowered because an acquisition is not providing the benefit that was expected will

depress the price investors will be willing to pay for a stock.

**Impairment Impact**

- AOL-Time Warner
- \$147 billion
- \$41 billion
- \$22 billion

A good example of this was when Time Warner purchased AOL

They paid \$147 billion for the purchase

Of this, \$41 billion was considered goodwill. It was pretty quickly obvious that Time Warner had overpaid for their acquisition because

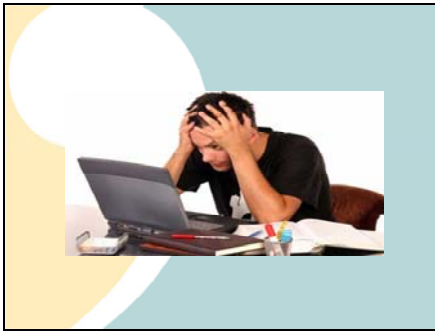
\$22 billion of this was written down as an impairment almost immediately. There was an approximately 41% drop in the share price because of that.

COMMONWEALTH BALANCE SHEET		
	March 31, 2011	December 31, 2010
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 1,279.0	\$ 1,271.2
Accounts receivable, net	1,282.4	1,212.2
Prepaid expenses and other current assets	213.2	202.0
Goodwill	2,222.4	2,222.4
Intangible assets	1,500.0	1,500.0
Property and equipment, net	2,282.2	2,282.2
Other non-current assets	2,282.2	2,282.2
Assets and liabilities acquired in connection with business combinations	24,218.4	24,218.4
Deferred tax assets	11,212.2	11,212.2
Other non-current assets	11,212.2	11,212.2
Liabilities and stockholders' equity		
Liabilities:		
Accounts payable	\$ 282.2	\$ 282.2
Accrued expenses	282.2	282.2
Deferred tax liabilities	1,212.2	1,212.2
Other non-current liabilities	1,212.2	1,212.2
Liabilities and stockholders' equity	2,282.2	2,282.2
Stockholders' equity:		
Common stock, \$0.01 par value, 107 million shares authorized, 107 million shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively	1.1	1.1
Additional paid-in capital	3,405.5	3,405.5
Accumulated other comprehensive loss, net	(273.1)	(273.1)
Accumulated deficit	(2,152.0)	(2,152.0)
Stockholders' equity	2,322.5	2,322.5

If you own a company that is growing by acquiring other companies,

you will see the amount of goodwill that has come from those acquisitions on its balance sheet,

in the top section where all the company assets are listed.



So how can you tell if a company might have to take a goodwill impairment charge?

AOL Inc.		
Consolidated Balance Sheet		
(In millions, except share and per share amounts)		
	June 30, 2011	December 31, 2010
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 487.1	\$ 501.8
Accounts receivable, net of allowance of \$13.1 and \$13.1, respectively	89.8	89.8
Prepaid expenses and other current assets	122.2	122.2
Goodwill	2,222.4	2,222.4
Intangible assets	1,500.0	1,500.0
Property and equipment, net	2,282.2	2,282.2
Other non-current assets	2,282.2	2,282.2
Assets and liabilities acquired in connection with business combinations	24,218.4	24,218.4
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Additional paid-in capital	3,405.5	3,405.5
Accumulated other comprehensive loss, net	(273.1)	(273.1)
Accumulated deficit	(2,152.0)	(2,152.0)
Stockholders' equity	2,322.5	2,322.5

Well, first you can compare its book value to its market value. Here's the most recent balance sheet for AOL.

In the stockholders equity section,

<b>Stockholders' equity:</b>	
Common stock, \$0.01 par value, 107.0 million and 106.7 million shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively	1.1
Additional paid-in capital	3,405.5
Accumulated other comprehensive loss, net	(273.1)
Accumulated deficit	(2,152.0)
<b>Total stockholders' equity</b>	<b>2,322.5</b>

- \$1.197 Billion
- \$1.197 < \$2.323

You'll find the number of shares currently outstanding of the company stock.

As you can see here, there are currently 107 million shares of AOL stock issued and outstanding as of June 30, 2011. AOL recently closed on Aug. 9 for \$11.19 per share.

If you multiply the stock price by the number of shares, the total market value of AOL was around 1.197 billion dollars.

The current book value of the company which is also called the shareholder equity was 2.323 billion dollars.

The market value is less than the book value meaning this is a company who may be a candidate for an impairment write-off.

Current assets				
Cash and equivalents	\$	456.7	\$	801.8
Accounts receivable, net of allowances of \$11.0 and \$16.1, respectively		285.8		307.7
Prepaid expenses and other current assets		52.1		48.8
Deferred income taxes		123.0		92.9
<b>Total current assets</b>		<b>917.6</b>		<b>1,251.2</b>
Property and equipment, net		446.4		528.2
Goodwill		1,072.2		813.6
Intangible assets, net		175.1		89.6
Long-term deferred income taxes		227.4		298.4
Other long-term assets		43.2		25.0
<b>Total assets</b>	<b>\$</b>	<b>2,879.1</b>	<b>\$</b>	<b>2,982.1</b>

In the assets section of the balance sheet, you can see that AOL has about

1.072 billion dollars of goodwill. Almost half of its current equity is goodwill.

**Impairment Charge**

- \$2.323-\$1.072
- = \$1.251 billion
- \$1.197-\$1.251
- 54 million

We can even get an idea of what the impairment charge might be

we first subtract the goodwill from the shareholders equity.

This gives us an estimate of what the company might receive if it was forced to liquidate today.

We then compare this to the current market value of 1.197 billion.

The market believes AOL is worth 54 million less than the sum of its identifiable tangible and intangible net assets. It is attaching no value to the 1.072 billion dollars of goodwill. Unless earnings improve and the market regains confidence in AOL's ability to produce, this is another strong indicator that an impairment charge may be imminent.

**Goodwill**

How much is too much?

That is the fundamental problem with having too much goodwill. If you made a bad decision and your investment in another business is not paying off, you will eventually have to recognize this with an impairment charge which will mean a serious hit to your earnings.

Companies with lots of goodwill will be even more exposed if the down market we are currently experiencing continues for a while. In a way you can consider too much goodwill in the same way you think about too much debt. It's an extra burden management has to deal with to run a profitable company. If things are going great, it may not be a problem but if the going gets tough, it may make it more difficult to make forward progress.



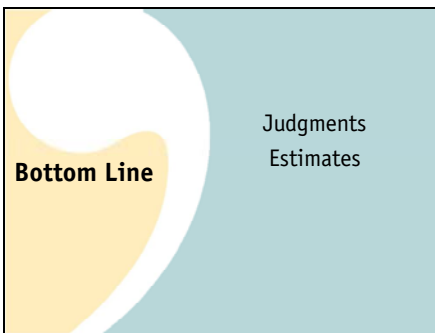
	June 30, 2019	December 31, 2018
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 40,204	\$ 106,881
Receivables, net	218,828	301,088
Inventory	28,859	32,295
Prepaid expenses	121	10,853
Property and equipment, net	12,972	12,292
Goodwill	1,063,000	1,012,913
Other intangible assets, net	92,719	89,832
Other assets	28,444	31,388
<b>Total Assets</b>	<b>\$ 1,477,147</b>	<b>\$ 1,508,552</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 11,201	\$ 14,417
Accounts receivable	51,380	41,378
Deferred portion of related liabilities	17,280	18,880
Other accrued liabilities	36,520	28,811
Income taxes payable	788	763
Deferred income	8,889	6,294
Liabilities of discontinued operations	2,308	2,384
<b>Total Current Liabilities</b>	<b>128,666</b>	<b>125,317</b>
Long-Term Liabilities, Contingencies, Leases Payable	25,640	26,286
Deferred Income Tax Liabilities	88,821	88,038
Other Noncurrent Liabilities	52,978	45,982
Contingencies and Contingencies		
Noncurrent Equity		
Common stock, \$0.01 par value, 100,000,000 shares authorized, 345,170,000 and 345,488,070 shares issued and outstanding as of June 30, 2019 and December 31, 2018, respectively	1,402	1,402
Additional paid-in capital	88,183	89,784
Retained earnings	342,478	338,520
Accumulated other comprehensive income	2,003	2,121
<b>Total Stockholders' Equity</b>	<b>\$ 1,318,300</b>	<b>\$ 1,378,701</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 1,477,147</b>	<b>\$ 1,508,552</b>

It's good to keep an eye on what percentage of total assets are made up of goodwill. For example, here's the latest balance sheet for LKQ corp. You can see that

Their Goodwill at approximately 1.063 billion dollars is almost half of their

total assets of approximately 2.4 billion dollars and about

70% of their shareholder equity of 1.536 billion dollars. This is something to keep an eye on as you watch their earnings and their market value. They will need good, growing earnings to sustain this level of goodwill.



In summary, acquisitions provide lots of opportunities where

judgments

and estimates need to be made. Caution must be used when projecting future earnings for companies that have recently combined based on past financial history.

If a company you have invested in is making lots of acquisitions, make sure you stay on top of how they are doing and what percentage of their balance sheet is goodwill.