P/E Ratios and Accounting for Goodwill

Measuring stock value in the fine print

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The P/E ratio is used as a quick way to see how cheap or expensive a stock is, and is particularly useful when comparing companies in the same industry. The P stands for Price, the E for Earnings. The ratio is simply the stock price divided by the Earnings Per Share (EPS). The stock price fluctuates over time, but is easy to get. More difficult is deciding what earnings to use when calculating the P/E ratio.

Some investors prefer to use the past actual earnings, or "12-month trailing" earnings in the denominator. Others prefer to use "forward" earnings estimates. In a perfect world, the P/E ratio using forward earnings would be a better judge of value, since a stock's value is dependent on a company's future prospects. Forward earnings are generally the average consensus of future earnings by the analysts that follow the stock. Problems can arise from using this number, since there is often a wide range in analysts' future estimates, and they have turned out to too hopeful many times.

Anything that affects the earnings number used will change this ratio, and the accompanying perception of whether it is “cheap” or “expensive”. There are many kinds of earnings. Simply put, it is revenue minus expenses, or what's left over after a company pays all its bills. Also known as net income or net profit, earnings are reported on a quarterly basis by all publicly traded companies.

Another type of earnings you will see goes by the acronym EBITDA, which means earnings before interest, taxes, depreciation, and amortization. This allows you to see a company's operating cash flow. While not a substitute for earnings per share, together with debt, it is a useful tool for valuing a company.

More common in press releases recently are pro forma earnings. These are often referred to as “earnings before all the bad stuff”. The original reasoning behind this is that taking out any unusual, one-time charges will allow investors to make a better comparison with earnings from previous years. This used to be primarily used after mergers and takeovers, but they seem to have been overused lately, as nearly every company that loses money blames it on "one-time" charges. Of course any company that continues to release pro forma earnings quarter after quarter indicates to me that these are not in fact "one-time charges", but merely poor management.

One of the most important intangible assets on a company's balance sheet that can have a large affect on earnings is goodwill. This year there has been an important change in how goodwill must be accounted for that will have a big impact on reported earnings for many companies, particularly over the next two years. This modification was passed in July, 2001 by FASB (the governing body of accountants), and companies whose fiscal year ends in December had to adopt the new rule at the beginning of 2002.

Here's how Goodwill works: When one company buys another, it usually pays more than the value of the selling company's physical assets. For instance, a company with $5 billion in facilities, property and goods might have trademarks, intellectual property, or knowledge that makes the company worth $10 billion to the acquirer. The premium paid over the value of physical assets is known as goodwill. It is shown on the balance sheet an intangible asset.

Before this change, goodwill, like any asset, needed to be amortized over time, often for as long as 40 years. That amortization takes a little chunk out of earnings each time. But under the new rules, companies won't have to regularly write down the value of goodwill anymore. Instead they will assess, on a periodic basis, if the value of their goodwill has changed. If they determine that it has lost value, they have to write it down. If a company changes how they report earnings in regards to the amortization of goodwill, FASB wants companies to go back and recalculate past periods in the same way so investors can easily compare year-to-year results and gauge earnings growth. They are required to do this only in footnotes to their income statements, however.

This change will have a big impact on some companies. Take AOL Time Warner, for example. When they first announced the merger in February, 2000 they estimated goodwill would be $190 billion, and planned to write off $7.6 billion per year for 25 years. Under the new rules, they had to write down any impairment in its market value, which in this case was the amount Time Warner stock dropped in the time between when the initial merger agreement was struck and the actual closing a year later. Media stocks had plummeted while they waited for the merger's approval, so it was about $54 billion. This led to a $12.25 per share loss for the first quarter (vs. EPS for all of 2000 of $0.45). Yet when the earnings announcement came out, it trumpeted the $0.18 per share "pro-forma" earnings.

The value of goodwill on the balance sheet before this write-off was $127 billion (more than its market cap at the time), and the amortization of goodwill was eating up over 50% of AOL earnings. How will this impact future earnings? After taking this charge, earnings will immediately double and the P/E ratio will be cut in half. Will the stock really be that much of a bargain compared to the past because of this change in a non-cash item? Of course not.

Changing how goodwill is accounted for should not have much of an impact on analysts and investors who follow technology companies. They usually look stick to pro forma earnings, which are already stated before such things as amortization of goodwill are taken into account. However, that may change in the future.

Investors now seem wary of all the pro forma accounting since the many accounting scandals this year, and many companies, even technology companies, have begun using GAAP again. Still, investors shouldn't be surprised if year-over-year earnings comparisons suddenly look amazingly good after 2002 and, by P/E standards, many stocks suddenly look very cheap.