**ARE 4TH QUARTER WRITE-OFFS LOOMING FOR DELOITTE’S CLIENTS?**

***Anthony H. Catanach Jr. and J. Edward Ketz***

***Grumpy Old Accountants, November 2011***

The Big Four accounting firms (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers) have filled the popular press this past year with numerous examples of their poor auditing practices. But the past month has been particularly bad for these “[’gatekeepers’ to the public securities markets](http://www.sec.gov/news/speech/spch518.htm).” The auditing practices of the Big Four are once again on the front page as Ernst & Young, KPMG, and PricewaterhouseCoopers now must explain their audits at [MF Global](http://www.mmexecutive.com/news/MF_Global_PwC_Jon_Corzine_commingled_funds_sovereign_risk_CFTC-224782-1.html) and [Olympus](http://www.businessweek.com/news/2011-11-11/financial-scandal-aficionados-never-had-it-better-jonathan-weil.html). And Deloitte is still reeling from its public humiliation at having its [weak quality control procedures](http://www.reuters.com/article/2011/10/17/us-deloitte-pcaob-idUSTRE79G6EQ20111017) exposed by the Public Company Accounting Oversight Board (PCAOB). These new cases simply support further the arguments we raised in [Big 4 Audits: A Thing of the Past?](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/342) and [Accountants Behaving Badly](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/332).

On October 17th, the [PCAOB released](http://pcaobus.org/News/Releases/Pages/10172011_DeloitteReportStatement.aspx) Part II of Deloitte’s May 19, 2008 PCAOB inspection report, in which it described deficiencies that suggest that Deloitte’s audit model may not “provide sufficient assurance that the Firm’s audit work will meet applicable standards and requirements.” Particularly damning was the PCAOB’s concern that Deloitte does not perform enough audit work evaluating management estimates, specifically as they relate to asset impairment tests. Deficiencies included failure to review valuation model assumptions, as well as not documenting the valuation of purchased intangibles.

We suspected that Deloitte might have some issues when we stumbled across the goodwill impairment issue at Dicks Sporting Goods which we discussed in [Goodwill Games](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/89). Given that most all corporate balance sheets today include some type of intangible asset (e.g. goodwill, identifiable intangibles, deferred tax assets, etc.), as well as Deloitte’s apparent audit model issues in this area, we decided to help Deloitte with its 2011 audits by identifying for them those clients where intangible asset impairment is very likely lurking.

So exactly how does one audit intangible assets, those that you can’t hear, see, smell, taste, or touch? Auditors generally resort to simply evaluating management’s estimates of the asset’s valuation (SAS 57), or they evaluate the work of a specialist hired by the audit client to value the intangible (SAS 73). It’s no wonder the PCAOB came down so hard on Deloitte, since there just don’t seem to be many substantive audit procedures to detect asset impairment for intangibles.

We have a relatively simple method to screen for possible impairment write-downs, which we will now share with Deloitte. The answer is *Return on Equity (*ROE)! At or above average ROEs suggest that a company’s assets are performing well, or maybe that the company also has some unrecorded intangibles which are creating “excess” revenue and cash flows (e.g., a secret formula or process perhaps). Alternatively, below average or negative ROEs indicate that a company’s assets are performing poorly or not at all. So, if a company’s balance sheet is dominated by intangible assets, AND the company is reporting a weak ROE, we simply ask: *what assets possibly could be the problem…the ones you can see, or the ones you can’t?* Oh, and by the way, our approach is entirely consistent with the FASB’s new position on goodwill impairment testing which indicates that financial performance should also be considered in testing impairment. See [Simplifying Goodwill Impairment Testing](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/315).

To help Deloitte out with their intangible asset auditing problems, we tapped the Wharton Research Data Services COMPUSTAT North America data set to create a list of Deloitte’s 2010 clients that reported intangible assets (i.e., goodwill, common identifiable intangibles, and deferred tax assets). We then computed ROE’s for each client company using 2010 net income and end-of-period shareholder equity. Only those companies reporting ROEs less than 10 percent were retained in our analysis. While this ROE is about 40 percent less than [Warren Buffett’s investment criteria](http://www.buffettsecrets.com/return-on-equity.htm), remember that we are auditing here, not investing. We are hunting for non-performing intangible assets. Finally, we searched the remaining companies in our pool to determine if they had reported any significant goodwill or intangible asset write-downs or restructuring costs during the preceding three years. If they did, these companies also were deleted from our pool, as they apparently had identified and initiated action on the impairment issue. These write-downs also no doubt negatively affected reported ROEs.

The result? The table below reports 24 companies that we believe are at significant risk for some type of intangible asset write-down in the very near future, sorted by the ratio of total intangible assets to total assets.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Company** | **Total Intangibles** | **Goodwill/**  **Total Intangibles** | **Total Intangibles/**  **Total Assets** | **Tangible Equity** | **ROE** |
| AMSURG CORP | 916 | 97.66% | 78.56% | -30.18% | 8.83% |
| INFUSYSTEM HOLDINGS | 102 | 63.03% | 78.00% | -12.69% | -2.18% |
| ARCHIPELAGO LEARNING | 208 | 79.71% | 77.87% | -37.67% | 3.22% |
| EPIQ SYSTEMS | 371 | 79.37% | 77.66% | -8.97% | 4.24% |
| VERISK ANALYTICS | 935 | 67.66% | 76.83% | -86.23% | -211.94% |
| NATIONAL CINEMEDIA | 635 | 0.00% | 74.29% | -122.36% | -7.11% |
| ROADRUNNER TRANS SVCS HLDGS | 248 | 99.51% | 71.24% | 5.05% | 1.35% |
| DIAMOND FOODS | 871 | 45.56% | 71.05% | -40.06% | 6.90% |
| GRUPO AEROPORTUARIO DEL CENT | 587 | 0.00% | 69.51% | 5.47% | 7.06% |
| ON ASSIGNMENT | 237 | 84.25% | 69.50% | -5.15% | -4.51% |
| UNIVERSAL HOSPITAL SERVICES | 575 | 48.71% | 69.06% | -51.44% | -19.84% |
| PENTAIR | 2,678 | 77.15% | 67.39% | -14.71% | 9.45% |
| NATIONAL MENTOR HOLDINGS | 683 | 33.64% | 67.23% | -45.07% | -3.05% |
| COMCAST CORP | 79,562 | 18.80% | 67.12% | -29.70% | 8.20% |
| APRIA HEALTHCARE GROUP | 1,474 | 51.58% | 66.95% | -36.72% | -2.62% |
| TOWERS WATSON & CO | 3,046 | 56.70% | 66.61% | -23.85% | 6.17% |
| GRUPO AEROPORTUARIO DEL PACI | 1,553 | 0.00% | 66.55% | 25.77% | 5.62% |
| CHINA REAL ESTATE INFO-ADR | 639 | 70.46% | 58.96% | 32.22% | 2.62% |
| VITAMIN SHOPPE | 269 | 65.79% | 55.47% | 22.61% | 9.82% |
| SOLTA MEDICAL | 86 | 57.34% | 54.43% | 22.52% | -1.65% |
| ASIAINFO-LINKAGE | 656 | 66.06% | 52.32% | 5.82% | 5.99% |
| QUEST SOFTWARE | 839 | 84.16% | 51.31% | 11.80% | 9.55% |
| PEGASYSTEMS | 172 | 13.14% | 51.02% | 6.96% | -3.01% |
| LANTHEUS MEDICAL IMAGING | 249 | 6.32% | 50.13% | -19.19% | 3.24% |

Why are these companies at risk? Just look at the percentages: high percentages of invested assets in intangibles, low or negative tangible stockholders equity, and anemic ROEs. Clearly, assets are not performing and which ones might those be? You got it: the ones you can’t see (or audit)…the intangibles!

So there you have it, Deloitte. We have identified firms with underperforming assets which more likely than not have incurred impairment losses. You can now honor your commitment to the investing public and require management to purge corporate balance sheets of fake assets.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*