A Primer on Bargain Purchases and Negative Goodwill

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Background

When a change of company control occurs, such as an acquisition, a valuation of the assets acquired must be performed to be GAAP compliant, as mandated by the Financial Accounting Standards Board (FASB) and addressed in Accounting Standards Codification (ASC) 805: *Business Combinations*. This type of exercise is commonly referred to as a purchase price allocation, since the purchase price of the subject company is allocated across all tangible and intangible assets acquired. Generally, the value of the subject company is greater than the value of the acquired assets, or in other words, "the whole is greater than the sum of the parts." That additional value is referred to as goodwill. But what if the sum of the parts is greater than the whole? There are certain transactions in which the total value of the individual assets acquired in a transaction exceed the price paid for the total company. This is often referred to as a "bargain purchase." The scope of this paper is to look at transactions involving fair value and bargain purchases, the differences between the two, and how bargain purchases should be addressed. Because of our experience with appraisals for asset-based lending purposes and with asset liquidations, Great American Group has significant experience in the field of bargain purchases, and handles numerous purchase price allocations involving a bargain purchase every year.

Transactions with Positive Goodwill

In a typical acquisition, acquired tangible assets may include working capital (accounts receivable, inventory, etc.), fixed assets (machinery and equipment), and real estate. In addition, there are a number of intangible assets that are often acquired, which are seen as the "value-drivers" of the company. An asset must pass one of two tests to have allocated value: 1) it must be of a legal or contractual nature; or 2) it must be separable from the business. Such intangible assets can include a brand name, patented or unpatented technology, certifications or licenses, noncompetition agreements, customer relationships, as well as industry-specific forms of intangible assets, such as spectrum rights or fishing quotas.

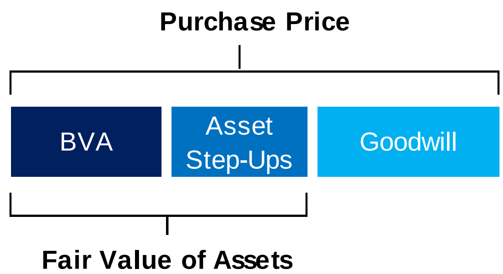
In this exercise, any excess value after allocating value to all of these assets is considered goodwill. Hence, the aggregate fair value of the acquired assets plus the fair value of goodwill equals the purchase price of the transaction, assuming the overall transaction itself is conducted at fair value.

Purchase accounting requires the use of the standard of Fair Value, which is defined in ASC 805 as:

"... the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

An important concept of this definition is that of a "market participant," which is an actual or theoretical potential buyer of the business or asset (or assumer of the liability). ASC 805 does not require that specific market participants be identified, only that their characteristics be described.

The difference between the book values of the assets (BVA) acquired and the fair values of those assets represents a step-up in the basis for the acquired assets. A diagram showing BVA, the step-up from BVA to fair value, and goodwill as components of the purchase price is shown in the figure below.



There are many ways to describe what comprises goodwill, but often it includes the acquired company's workforce, prospects for future growth, market participant synergies with the target company, and "going concern value" from the assemblage of the assets. Below is a sample of what a purchase price allocation may look like for a $50 million acquisition ($ in 000s):

Assets	**Fair Value**
Net Working Capital	15,000
Net Fixed Assets	10,000
Real Property	1,000
Identified Intangible Assets:	
Patents and Technology	5,000
Trade Name	7,000
Customer Relationships	4,000
Unallocated Intangible Assets	
Trained and Assembled Workforce	500
Goodwill	7,500
Purchase Price	**50,000**

As you can see, the fair value of the acquired assets sums up to $42.5 million, which means that the residual $7.5 million left over will fall into goodwill. It is also important to note that while the Trained and Assembled Workforce (TAW) is listed separately, it is generally not viewed as separable from the company and hence is bundled into goodwill on the subject company's balance sheet, but for purchase price allocation purposes it is listed separately.

Transactions with Negative Goodwill

While most transactions have positive goodwill, occasionally the fair value of the acquired assets exceeds the purchase price. This scenario results in negative goodwill and is commonly referred to as a bargain purchase. Using the previous example, if the purchase price was only $40 million instead of $50 million, the allocation would look like this:

Assets	Fair Value
Net Working Capital	15,000
Net Fixed Assets	10,000
Real Property	1,000
Identified Intangible Assets:	
Patents and Technology	5,000
Trade Name	7,000
Customer Relationships	4,000
Unallocated Intangible Assets	
Trained and Assembled Workforce	500
Fair Value of Identified Assets	**42,500**
Goodwill	(2,500)
Purchase Price	**40,000**

This type of scenario creates a significant amount of additional analysis, which we will describe in further detail.

Characteristics – Initial Screening

There are several telltale signs that a transaction may be a bargain purchase. Two common themes are information asymmetry and company distress. Some earmarks of bargain purchases include:

- The subject company has incurred financial losses in recent years
- The net book value of the acquired assets exceeds the purchase price
- The transaction was not well marketed (i.e., a limited number of potential buyers were contacted)
- There was only one bid for the subject company
- The subject company was acquired over a very short timeframe
- The seller was compelled to sell the business
- The buyer acquired the subject company without using a formal set of projections
- The existence of information asymmetry, in which the buyer knows more about the future prospects of the business than the seller

As with any purchase price allocation, there should be a story associated with the transaction as to why it was a bargain purchase, and steps should be taken to document why a bargain purchase is representative of fair value. If you can't clearly articulate why the purchase price allocation should have negative goodwill, you may need to revalue each asset, or conclude that the fair value of the overall business is more than the purchase price (i.e., the transaction did not occur at fair value). In that case, the concluded fair value is the amount allocated to the acquired assets and goodwill, and the excess of the fair value of the business above the purchase price would be recorded as an extraordinary gain.

Valuation Characteristics

Since a bargain purchase often implies that the subject company has endured some form of financial distress, the fair value of the acquired assets is often depressed as well. A few examples are stated below.

Inventory – Occasionally, the fair value of the subject company's inventory will be required, particularly if inventory comprises a large portion of the company's assets. If the fair value of the inventory is greater than its net book value (NBV), it is referred to as an "inventory step-up." In a bargain purchase scenario, however, the fair value of the inventory could be lower than its NBV, which would be referred to as an inventory step-down. For example, the inventory's fair value might be less than its NBV due to low gross margins, low turnover, product obsolescence, raw material price changes, or high fixed costs.

Fixed Assets – One common characteristic of a company acquired under a bargain purchase is that the company has excess, underutilized, or non-operating fixed assets on the balance sheet. In such a case, it can be inferred that the cash flows of the subject company do not support the fair values of the fixed assets as a going concern. This situation can be rectified by applying economic obsolescence to the fixed assets, thereby writing the assets down to create a fair value in which the cash flows of the business do support the fixed assets. One must be aware of both the macro and micro impacts of applying this analysis. Applying too much economic obsolescence to fixed assets can push a bargain purchase into a positive goodwill scenario. When applying economic obsolescence to fixed assets, typically the lower-end constraint is orderly liquidation value, also known as value in-exchange. The case for economic obsolescence is that there are not enough cash flows to support ownership of the fixed assets. Therefore, it would be self-contradicting to state that there is insufficient cash flow to support the full value of the fixed assets in-use, and yet also conclude that there is cash flow beyond that generated by the aggregate assets. In other words, economic obsolescence and residual goodwill do not typically both exist in the same operating unit in a transaction setting.

Customer Relationships – One intangible asset that is present in nearly every purchase price allocation is customer relationships. As one may infer, this asset represents the value of the company's power to generate future sales from its existing customers. This asset is often valued using a methodology called the Multi-Period Excess Earnings Method (MPEEM). The MPEEM attempts to isolate the value of the customer relationships by assuming a scenario in which the buyer would only own the customer relationships and all other assets (i.e., working capital, fixed assets, trade name, etc.) are rented. The cash flows of the business are therefore reduced by economic rents, or "contributory asset charges," which are the theoretical costs of renting all of the other assets. The excess cash flow that remains is referred to as the "excess earnings," which are then discounted to calculate the fair value of customer relationships.

Another characteristic often found in bargain purchases is that since the company frequently does not generate enough cash flows to support the assets of the business, the contributory asset charges applied in the MPEEM often end up consuming all of the cash flows used in calculating the fair value of customer relationships. In such cases, it is often necessary to explore other valuation methods for the customer relationships so that the value of the customers reflects economic assumptions a market participant typically would have made regarding those assets. While it is very rare to have both economic obsolescence and residual goodwill, it is not uncommon to have both economic obsolescence and value within the identified intangible assets such as customer relationships, trademarks, or patented technology.

Rates of Return – Commonly, as part of a purchase price allocation analysis, it would be expected that three rates of return would be in alignment: Weighted Average Cost of Capital (WACC, or a hypothetical return on the subject company calculated by the appraiser), Implied Rate of Return (IRR, the rate of return determined based on the projections used to price the acquisition and the ultimate purchase price), and Weighted Average Return on Assets (WARA, the aggregate rate of return required for each acquired asset weighted in proportion to the fair value of that asset to the purchase price).

In a bargain purchase scenario, however, these rates would often initially not be in alignment without further efforts to reconcile them. Financial theory predicts the following relationship: IRR>WACC>WARA. The IRR tends to be the highest because the subject company was purchased at a low price (hence a "bargain purchase") and this indicates that the buyer is requiring an above market rate of return on the investment. The WACC is in the middle because it is calculated without regard to the purchase price and hence is unaffected by the nature of the acquisition. The WARA tends to be the lowest rate of return because in a bargain purchase there is no goodwill, which typically has a higher required rate of return than any of the acquired assets, while goodwill would be present in the normal market assumptions associated with the WACC. This difference in the asset mix pushes toward a lower WACC, with all else being equal. In a bargain purchase scenario, the reconciliation of these differences can be a complex process.

Implications

The primary implication of a bargain purchase is the gain to the buyer if in fact the purchase actually was a "bargain" relative to the fair value of the acquired business. As discussed earlier, ASC 805 mandates that a bargain purchase gain be recognized at the time of acquisition and recorded as extraordinary income at the date of purchase. However, it is important to note that this is a gain for GAAP accounting only and hence this gain would not be included in the calculation of taxable income.

How to Handle a Bargain Purchase

In dealing with a bargain purchase, much of the natural support of market expectations provided by the transaction itself is missing. Therefore, extra analysis is necessary to ensure that the purchase price allocation represents the views of market participants in an accurate and supportable manner. As bargain purchases are somewhat rare, auditors tend to be skeptical of such a conclusion. Here are a few pointers to help smooth the process.

Find out as soon as possible – In doing the initial scoping of the appraisal, the appraiser should ask the client and/or auditor about the transaction and if a bargain purchase is anticipated. This can help to align expectations and generate a more thoughtful information request list as well as guide the discussions with company management and the auditors. This initial scoping may help determine the rationale for the bargain purchase, which will provide support for the analysis and report.

Over-communicate – If the analysis reveals a potential bargain purchase that was not anticipated, it is important to notify all relevant parties as soon as possible. This will help progress the appraisal when it is in audit review, as many of the questions auditors may have can be answered up front as opposed to during the review. If a fixed asset appraisal is being done as well, this should be communicated early on to the fixed asset appraisers, as they will likely need to apply economic obsolescence to the fixed assets.

Reconcile the rates of return – In looking at the three rates of return (IRR, WACC, and WARA), the appraiser should be able to explain why they are equal or far apart. In most cases, a separate valuation of the business should be performed to determine the actual fair value of the subject enterprise in order to support the rates of return used in the valuation of the individual assets.

Communicate the implications – Once it has been established that the transaction is a bargain purchase, it is important that the management of the subject company know how this will impact financial performance going forward.