Reporting Standards for Bargain Purchase Gain: Is the Objective Achieved?

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The Financial Accounting Standards Board's objective with respect to the reporting of business combinations is "to improve the relevance, representational faithfulness, and comparability of the information…." Yet, when a bargain purchase occurs, the excess of the fair value of the net assets acquired over the amount paid must be recognized immediately in income as a gain from bargain purchase. An analysis of a recent bargain purchase, however, questions whether that requirement allows current accounting standards to achieve the Board's objective in all cases. Suggestions are offered as possible enhancements to the standards.

PROLOGUE

A few years ago, I was in the market for a used boat motor and trailer (hereinafter bmt). After searching diligently for the best price, I was excited to find a real bargain. Other similar bmts were selling for three or four times the amount asked, and the seller even threw in the trailer hitch for free…that should have been a clue! The seller also included a paddle which obviously would be used for maneuvering in shallow water. After paddling six miles back to the launch the first time out, the real purpose of the paddle emerged. Seven months, no fish, and many dollars in repairs later, that contrary bmt was still not reliable. If I had been a company (Me Company) and the ornery bmt had been a company (Ornery BMT Company), Me Company would have recorded a gain upon purchasing Ornery BMT Company.

INTRODUCTION

The objective of the Financial Accounting Standards Board (FASB) with respect to accounting for and reporting of business combinations (the acquisition of one company by another company) is "to improve the relevance, representational faithfulness, and comparability of the information..." (FASB (2014) *Accounting Standards Codification* Topic 805, Business Combinations, Subtopic 10, paragraph 10-1). In its attempt to fulfill that objective, the FASB established standards requiring a purchasing company to recognize a gain from bargain purchase if the price paid for the acquired company is less than the fair value of its net assets. While this treatment may be appropriate for some business combinations, an analysis of a recent bargain purchase indicates that other accounting options may also need to be available to capture the economic substance of business combinations on an individual basis, rather than the one-size-fits-all requirement.

When one company purchases another company, the purchase price is often different from the market value of the net assets of the acquired company. For combinations in which the purchase price is more than the market value of the net assets, accounting requirements have been consistent. The acquiring company is deemed to be willing to pay that excess based on the belief that the acquired company has developed an intangible value. That intangible value is recorded as the asset, goodwill.

In contrast, the accounting profession has wrestled for many years to determine the appropriate measurement of and reporting for a purchase in which the acquiring company pays less than the market value of the net assets of the acquired company. This difference between the purchase price and market value of the net assets is currently recognized immediately in income as a gain from bargain purchase.

Under earlier accounting and reporting requirements this excess market value was designated as negative goodwill and was reported in the balance sheet along with other vague deferred credits. Later requirements were such that this excess market value was written off against the assets acquired (succeeding accounting requirements identified different methods and different assets to write down). A gain was recognized only if an excess remained after applying credit amounts to certain assets.

Under current accounting standards, the initial measurement of goodwill and of a bargain purchase gain is similar. Conversely, the classification and reporting of each is extremely different. Subsequent measurement and reporting of each is also quite different.

CURRENT ACCOUNTING REQUIREMENTS

At the Date of Purchase

Measurement

The same criteria are used to measure both the value of goodwill as well as the value of the gain from a bargain purchase. From FASB standards, the determination of goodwill follows:

> 30-1 The acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b):
>
> a) The aggregate of the following:
>   1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date fair value
>   2. The fair value of any noncontrolling interest in the acquiree
>   3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
>
> b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Topic. (FASB, 2014, *Accounting Standards Codification*, Subtopic 30 of Topic 805, Business Combinations)

With respect to the determination of a gain from bargain purchase, accounting standards further state:

> 25-2 Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in paragraph 805-30-30-1(b) exceeds the aggregate of the amounts specified in (a) in that paragraph. If that excess remains after applying the requirements in paragraph 805-30-25-4, the acquirer shall recognize the resulting gain in earnings on the acquisition date. The gain shall be attributed to the acquirer. (*Ibid*.)

Thus, the same measurement criteria apply in the determination of both goodwill and a gain from bargain purchase. In considering a bargain purchase, though, the standards continue:

> 25-3 A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. …

> 25-4 Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. (*Ibid*.)

The FASB includes paragraph 25-4 above to provide assurance that the amount (if any) of fair value excess over purchase price is measured correctly and carefully. Perhaps a similar requirement should be included for the measurement of goodwill.

Reporting

Goodwill is reported in the balance sheet as an intangible asset. This reporting requirement has been consistent for many years.

Gain from bargain purchase is reported immediately as a gain in the income statement in the year of the acquisition. The gain is then closed to retained earnings where it resides forever, oblivious to reality. This reporting requirement has changed considerably over time. Until Statement of Financial Accounting Standards No. 141 *Business Combinations* in 2001, the excess of the value of the net assets acquired over the consideration given was considered negative goodwill and was reported ambiguously as a deferred credit where it just sat around until amortized away.

Subsequent to Date of Purchase

Measurement

Early accounting standards required goodwill to be amortized over an arbitrary period of time until completely written off. Under provisions of the 2001 Statement of Financial Accounting Standards No. 141, goodwill is no longer amortized. Its value is currently required to be measured annually for an impairment loss. If goodwill is determined to be impaired, the account is written down, and a loss is recognized immediately in income. Although the criteria established for measuring the loss has been tweaked somewhat, the fundamental procedures of measurement to determine impairment and then reporting an impairment as a loss in income has been consistent since 2001.

The gain from bargain purchase is never re-measured.

Reporting

Goodwill (reduced by any impairment) continues to be reported as an intangible asset; impairments reduce the value of goodwill and are reported as losses in income.

The gain from a bargain purchase resides in retained earnings forever, unfettered by reality, and is never adjusted.

BARGAIN PURCHASE OF GENERAL MOTORS

General Motors Company (GM) purchased General Motors Strasbourg S.A.S. (GMS) in 2010. The following is an excerpt from the notes of the 2010 consolidated financial statements of GM:

> On October 1, 2010 we acquired 100% of the outstanding equity interest of General Motors Strasbourg S.A.S. (GMS) for cash of one Euro from MLC [Motors Liquidation Corporation]. …MLC was unable to sell GMS and upon notification of their plan to liquidate GMS, we agreed to repurchase the business. We believe the repurchase of GMS allows us to maintain good relationships and to help expand our business within the European region. (General Motors Company and Subsidiaries 2010 *Annual Report* Note 5, Acquisition and Disposal of Businesses, p. 162)

Along with recording the fair value of the assets acquired and liabilities assumed, GM recognized a bargain purchase gain of $66 million indicating that the net fair value of GMS was $66 million (minus one Euro). The notes further stated:

> We determined that the excess of fair value over consideration paid was attributable to potential future restructuring scenarios made necessary due to the uncertainty in sales demand beyond in-place supply agreements. Restructuring costs, if incurred, would be expensed in future periods. As potential future restructuring activities do not qualify to be recorded as a liability in the application of the acquisition method of accounting, none was recorded, and we recorded the excess as a bargain purchase gain. (*Ibid*.)

Two years later, an excerpt from the notes to the 2012 annual consolidated financial statements of GM reports the following:

> In December 2012 we entered into a definitive agreement to sell 100% of our equity interest of General Motors Strasbourg S.A.S. (GMS) …for cash of one Euro to an external third-party. GMS's assets and liabilities were adjusted to their estimated fair value of one Euro upon entering into the definitive agreement. The resulting charge of $119 million was recorded … (General Motors Company and Subsidiaries 2012 *Annual Report* Note 4, Acquisition and Disposal of Businesses, p. 88)

So, a little more than two years after this bargain purchase, GM lost not only the initial value of $66 million, which was recognized in income as a gain, but also an additional $53 million.

THE OBJECTIVE OF ACCOUNTING FOR BUSINESS COMBINATIONS

The FASB has defined its objective with respect to accounting for business combinations:

> 10-1 The objective of the Subtopics in this Topic that address business combinations is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. (FASB, 2014, *Accounting Standards Codification*, Subtopic 10 of Topic 805, Business Combinations)

The gain from bargain purchase, however, may not be relevant in certain situations. Results of research of market reaction to reported negative goodwill (the previous method of reporting the excess of fair value acquired over price) could not support the supposition that markets value negative goodwill. With respect to current accounting standards, however, the authors go on to conjecture that the additional reporting requirements for greater assurance that the amount (if any) of fair value excess over purchase price is measured carefully may lead to the market's assigning value to the gain from bargain purchase. (Comiskey et al., 2010) Nevertheless, GM's purchase of GMS clearly did not result in an economic gain. The possibility of any relevance being assigned to the gain from this bargain purchase, therefore, seems somewhat remote.

Moreover, the gain from bargain purchase may not always faithfully represent the substance of the acquisition. GM's gain on its bargain purchase of GMS certainly did not promise profitability or future positive cash inflows. On the contrary, GM provided additional resources and ultimately recognized losses in its unsuccessful attempt to make GMS profitable.

Finally, the comparability of financial information under these current standards is questionable. The requirement that all business combinations resulting in a bargain purchase are accounted for in the same way, as a gain from bargain purchase, does not always render the true economic substance of each purchase. While one purchasing company may have realized an economic gain, a second purchasing company may not have a real gain at all. Since the first company is reporting the economic substance of the transaction while the second company is not, the financial records of these two companies will not be comparable. Furthermore, the current method of accounting for a bargain purchase is not consistent with the accounting for business combinations that are not a bargain purchase.

To meet its own objective, therefore, the FASB needs to re-visit its one-size-fits-all requirement of immediate recognition in all instances of a gain from a bargain purchase.

ANALYSIS

In the norm, gains are realized when net assets are used or sold, i.e. when they are proven to be gains. Since the gain from bargain purchase has not been realized in the traditional way, the gain may be a pending (unrealized) gain (or possibly a future loss). One problem is that accounting exists in a plane geometry world; solid geometry solutions are not available. How does a company report the excess market value of a bargain purchase in this dichotomous (debit/credit) world of accounting? The requirement to value the net assets acquired at market is a positive move, but what about that dangling credit? First, a closer look at that credit.

From a general view, that dangling credit, consisting of excess market value over purchase price, arises because of two mutually agreeable sources, the seller and the buyer.

The seller has reason to be willing to accept less than market value for the net assets being sold. The seller understands that it must allow for extra time and incur additional costs in order to realize the market value of the individual assets. Further, once major assets begin to be sold, the company being sold will no longer be able to operate to produce cash inflows. LMT had no luck in selling GMS, and was willing to accept less than fair value of GMS' net assets rather than to incur additional time and costs to sell them.

The buyer is not willing to pay full market value to purchase those net assets. As with GM's purchase of GMS, the buyer recognizes that it will incur restructuring costs in order for the acquired company to be capable of operating profitably.

From the get-go, therefore, GM knew it was not getting a bargain purchase, and LMT knew it was not foregoing a potential gain on its sale of GMS.

With that perspective in mind, the agreed-on value of the transaction is fair value; so that dangling credit is clearly not a gain. However, since each of these costs (to the seller and to the buyer) would be future costs, under current accounting conventions neither can be accrued when recording and reporting the current purchase. So we are stuck with a misplaced credit.

On the other hand, due to mis-matches in future cost estimates by the buyer and the seller, purchase transactions do occur that are a true gain (in part or in whole) to the buyer. In those cases, the purchaser has realized an immediate benefit, and a gain from bargain purchase (to the extent of the value of the gain) should be recognized in income at the time of the purchase. Any amount not considered an immediate gain remains a dangling credit to account for.

SUGGESTIONS

What accounting and reporting procedures should be used when the amount paid is equal to (or only partially equal to) the fair value of the transaction even though less than the fair value of the net assets acquired—resulting in a dangling credit? Two possibilities for accounting for that credit are explored here, the contra-asset approach and the all-inclusive income approach. Under both approaches, the accounting profession would first establish recognition criteria for the purchasing company to use in its determination of how much, if any, gain is to be recognized at the time of purchase. These criteria, or additional criteria, would also be used annually to determine the appropriate accounting for any remaining portion of the bargain purchase.

Contra-Asset Approach

The contra-asset approach is consistent with accounting for goodwill; the excess credit would be recorded as it was in the past with negative goodwill. Different from past accounting, however, the credit would be classified as a contra-asset and reported with intangible assets in the balance sheet instead of being bundled with the indistinct deferred credits as was the case earlier. It would be classified as intangible because despite the fact that a void in value exists, the excess credit cannot be specifically attributed to any tangible assets.

This contra-asset approach is consistent with the cost basis and with conservatism while allowing the individual net assets to be recorded at market. While individual net assets are reported at market value, the entire purchase is valued at cost.

Similar to the evaluation of possible goodwill impairment, the acquiring company would use the established criteria, or additional criteria, to evaluate the contra-asset account. The acquired company would be evaluated each year, as in the case in which goodwill is recorded. The contra-asset account would be adjusted to reflect a realized gain (in whole or in part) when, after applying the criteria, the underlying value of the acquired entity is deemed to be creditable. In this way, the gain would be pending until proven.

On the other hand, if the criteria indicate questionable values of the acquired company requiring the write-down of specific assets, those assets would be written down to the contra-account. Any write-down amount exceeding the contra-account would be recognized as a loss.

All-Inclusive Income Approach

The all-inclusive income approach would initially record the excess credit as a gain in other comprehensive income, but not net income. This other comprehensive income account would be closed into accumulated other comprehensive income and remain there as a part of stockholders' equity until further adjustments are considered desirable. Hence, the individual net assets would be recorded at market, and the increase in worth to the company of the excess of the market value acquired over the consideration given would be recognized without an immediate and possibly overly-hasty impact on net income.

Similar to the contra-asset approach, the realization of the gain in income would be pending and would be recognized in income only after the determination that the acquired entity's net value is deemed to be appropriate. Using the established criteria, an annual evaluation of the acquired company would determine the probability of realization of the gain.

If this annual evaluation determines that the gain (in whole or in part) should be recognized, the accumulated other comprehensive income account would be adjusted and a realized gain would be recorded.

Conversely, if the value of the acquired company is not found to be reliable, the net assets would be written down to another comprehensive loss account. This other comprehensive loss account would be closed to accumulated other comprehensive income, eliminating the effect of the previously recorded other comprehensive gain. Any excess write-down amounts would be recognized in income as a loss.

Although the all-inclusive income approach is not as conservative as the contra-asset approach, it is more conservative than current requirements that recognize a gain from bargain purchase in income rather hurriedly. This approach has been suggested in earlier literature. (Comiskey et al., 2010) It also has the attribute of fully realizing the benefit to the stockholders of the market value of the net assets acquired.

CONCLUSION

Determining the best way to record, classify, and report the results of a company's acquisition of another company at a price that is less than the market value of the acquired company's underlying net assets has been elusive. The reporting requirements have changed over time with none of them seeming to reflect the economic substance of the acquisition in all cases. The market value of the net assets should be recorded, but without abandoning the cost basis, conservatism, or reality.

The example of GM's reluctant acquisition and then speedy disposal (at an additional loss) of GMS indicates that the current requirements of an immediate recognition of a gain from bargain purchase will not always properly reflect the economic substance of the acquisition. Although the possibility of a real bargain and a realized gain exists, the amount of gain to recognize, if any, needs to be proven through meeting established criteria.

Two alternatives to current accounting and reporting requirements have been proposed, the contra-asset approach and the all-inclusive income approach. Both are more conservative than current requirements while allowing the net assets of the acquired company to be recorded at market value. Both would recognize a gain in income only after determining that established criteria have been met. Both would postpone recognition of any questionable gain until (and unless) attaining satisfaction that the criteria have been met. As a result, the acquiring company would have the luxury of additional time to evaluate the productivity of the acquired company. It would also have the benefit of the established recognition criteria to utilize before recognizing the gain.

These approaches are also more consistent with the accounting for a purchase resulting in recognizing goodwill. The net assets acquired are recorded at market value, and the difference is recorded separately. Then, the value of this difference is tested annually as is goodwill.

The all-inclusive income approach also has the attribute of fully realizing the benefit to the stockholders of the market value of the net assets acquired. The contra-asset approach has the additional qualities of adhering to the cost basis and is more conservative than the all-inclusive income approach. This approach is also more consistent with the accounting and reporting requirements for goodwill.

EPILOGUE

Less than a year after my bargain purchase and after replacing a flat tire on the trailer, I gleefully gave the miserable bmt away—trailer hitch and paddle.

REFERENCES

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