Fair Value Measurements in Business Combinations and Bargain Purchase Transactions

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This discussion summarizes the fair value measurement guidance and financial accounting considerations in business combinations—and specifically in bargain purchase transactions. This discussion describes the principles of the acquisition accounting method as it relates to fair value measurement. And this discussion describes many of the valuation analyst considerations with regard to fair value measurements for a bargain purchase transaction.

The original version of this discussion was published in the Autumn 2018 issue of *Insights*. During our subsequent research on the subject of bargain purchase transactions, we found that such transactions continue to be rare. We performed a detailed search of publicly available financial information, and we located a few likely candidates.

Three of these transactions are described at the end of this discussion. It appears that the global pandemic may be driving a majority of these new bargain purchase transactions.

Introduction

Is the old saying true that "everyone loves a bargain"? In business combinations, buyers look for a "bargain" while sellers attempt to negotiate the highest possible price. Although true bargains exist in the marketplace, each party in a transaction is generally unwilling to consider a price that varies significantly from its individual perceived value of the transferred assets or business.

For financial accounting purposes, the business combination purchase price is compared to the estimated *fair value* of net assets acquired. According to the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820, fair value is defined 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."

In certain business combination transactions, the buyer may pay something greater than the fair value of the assets acquired due to synergies and a host of other reasons.

In other business combination transactions, the buyer may:

1. pay less than the estimated fair value and
2. be considered to have consummated a bargain purchase.

Bargain purchases in business combinations may require additional considerations for both financial accounting and valuation professionals.

This discussion summarizes the financial accounting, fair value measurement, and valuation analysis considerations related to business combinations involving bargain purchases.

Additionally, this discussion considers the Security and Exchange Commission ("SEC") scrutiny of fair value measurements.

Financial Accounting Considerations

The FASB ASC Topic 805 provides guidance on the financial accounting considerations for business combinations accounted for by application of the acquisition method.

To comply with U.S. generally accepted accounting principles ("GAAP"), the business combination buyer records the transaction using the acquisition method and measures the following:

1. Tangible assets and liabilities that were acquired
2. Intangible assets that were acquired
3. Amount of any noncontrolling interest in the acquired business
4. Amount of consideration paid
5. Any goodwill or gain on the transaction

Applying generally accepted valuation approaches and methods, the purchase price is allocated between:

1. identifiable tangible assets and identifiable intangible assets and
2. purchased goodwill.

However, if the fair value of the identifiable net assets exceeds the business combination purchase price, a *bargain purchase* has occurred under the rules of ASC Topic 805.

The FASB defines a bargain purchase as "a business combination where the acquisition date amounts of identifiable net assets acquired, excluding goodwill, exceed the sum of the value of consideration transferred."

The net effect of such a transaction is, essentially, negative goodwill. In the event of a bargain purchase, the purchaser is required under GAAP to recognize a gain for financial accounting purposes. The effect of this gain is an immediate increase to net income.

A reasonable person may question the frequency or volume of bargain purchases. After all, businesses along with savvy owners and boards of directors do not often willingly sell assets below fair value.

In fact, both the FASB and the International Accounting Standards Board ("IASB") consider bargain purchases to be anomalous transactions. Still, these transactions do occur on occasion.

One notable bargain purchase was the acquisition of Lehman Brothers by the U.K. bank Barclays in late 2008, resulting in a negative goodwill gain for Barclays of £2.26 billion (approximately $4.1 billion U.S.) (i.e., the £3.14 billion difference between the assets and liabilities acquired minus the acquisition cost of £874 million).[1]

There were likely hundreds of other such transactions in the aftermath of the 2008 market crash and the subsequent Great Recession. Other potential causes of bargain purchases include liquidations, distressed sales, and non-arm's-length transactions. In general, bargain purchases appear to occur at increased frequency during times of economic crisis.

As discussed in a later section, the ongoing global pandemic may lead to increased bargain purchases during 2020 and through 2021.

In addition to the previous example, we know that bargain purchase issues continue to occur. In August 2017, the SEC issued an order instituting public administrative and cease and desist proceedings against a Big 4 accounting firm and one of its partners involving, in part, bargain purchase issues.

Of the numerous alleged violations, perhaps the most relevant to the topic of bargain purchases was *failure to properly test fair value measurements and disclosures and using the work of a specialist*. The accounting firm and the audit partner were ultimately fined more than $6 million.[2]

Accounting Guidance on Business Combinations and Fair Value Measurement

GAAP requires that business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (December 15, 2009, for acquisitions by not-for-profit entities), account for the transaction under ASC Topic 805.

ASC Topic 805 focuses on the following areas:

1. Provides broad definitions of business and business combinations (the FASB issued new guidance, Accounting Standards Update

["ASU"] 2017-01, *Business Combinations* (Topic 815)): *Clarifying the Definition of a Business*, in January 2017 that amends the previous definition of a business)

2. Requires the use of the acquisition method
3. Recognizes assets acquired and liabilities assumed at fair value as defined in ASC Topic 820—*Fair Value Measurement*

First, a business is defined in ASU 2017-01 as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return." A business combination is defined as "a transaction or other event in which an acquirer obtains control of one or more businesses."

Generally, GAAP identifies that greater than 50 percent of the voting shares of an entity indicates control. However, effective control may exist with a lesser percentage of ownership in certain circumstances.

Second, the acquisition method is required by ASC Topic 805. And, the acquisition method involves the following procedures:

1. Identifying the acquirer
2. Determining the acquisition date
3. Determining the consideration transferred
4. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
5. Recognizing and measuring goodwill or a gain from a *bargain purchase* [emphasis added]

Third, ASC Topic 805 requires that all identifiable assets and liabilities acquired, including identifiable intangible assets, be assigned a portion of the purchase price based on their fair values. Fair value measurement emphasizes market participant assumptions and exit values.

Finally, when measuring fair value, the following issues should be considered:

1. Market participant assumptions—Buyers and sellers with *all* the following characteristics:
   a. Independent (not related parties)
   b. Knowledgeable
   c. Able to transact
   d. Willing but not compelled to transact
2. Highest and best use—Assumes the asset's utility is maximized and the use of the assets is physically possible, legally permissible, and financially feasible at the measurement date
3. Synergies—Are excluded unless feasible at the market participant level

The Financial Accounting for Business Combinations

Accountants provide a pivotal role in the analysis and financial accounting of business combinations through purchase price allocations.

The first procedure in accounting for a business combination is recognizing and measuring the identifiable assets acquired, the liabilities assumed, the consideration transferred, and any noncontrolling interest in the acquired company. The accountants generally rely on valuation analysts ("analysts") to measure fair values. ASC Topic 805 provides guidance in each of these areas.

Once the tangible assets are identified, those assets are generally valued by reference to the market approach or the income approach—unless there are insufficient data to do so. In these instances, the analyst may use the cost approach and the replacement cost new less depreciation method. Any liabilities assumed may be valued in the same manner.

The fair value measurement of intangible assets can be complex. Acquired intangible assets are accounted for separately from goodwill if the acquired intangible assets:

1. possess contractual or legal rights or
2. can be transferred from the acquired entity.

Examples of identifiable intangible assets include patents, copyrights, trademarks, customer lists, noncompete agreements, and assembled workforce.

There are several valuation methods available to measure the fair value of intangible assets. A description of these intangible asset valuation methods is beyond the scope of this discussion.

ASC Topic 805 requires that all consideration transferred and any noncontrolling interests be measured at fair value as of the acquisition date. Additionally, the fair value of any contingent consideration (i.e., earn-out provisions) is typically estimated by probability weighting outcomes via various risk simulation tools.

If at the end of the accounting process, the consideration transferred (or purchase price) is greater than the fair value of the assets and liabilities, the difference is recorded as goodwill.

Alternatively, if the fair value of the assets and liabilities is greater than the consideration transferred (or purchase price), a bargain purchase exists with immediate impact to the buyer's income statement (no such burden accrues to the seller).

Acquirers often engage an analyst to develop the fair value measurements.

Fair Value Measurement Considerations for Business Combinations

The analyst's role is important in the fair value measurement for purchase price allocation purposes. As with most purchase price allocations, the first procedure the analyst generally takes in assessing a bargain purchase transaction is to identify all assets, liabilities, and consideration transferred.

If early value estimates indicate that a bargain purchase may exist, the analyst may notify the accountant and other stakeholders—as this indication may impact the buyer's income statement.

Assets are typically valued using the cost approach, the market approach, or the income approach. These generally accepted property valuation approaches are also used to value the liabilities and the consideration transferred. The analyst typically considers all three generally accepted valuation approaches and provide explanations for the inclusion or exclusion of each approach.

The analyst should document the rationale for the valuation approaches both considered and employed in arriving at a value estimate. This documentation provides context for the parties involved in the bargain purchase transaction.

Given the nature of bargain purchase transactions, it can often be difficult to implement a market approach. This fact can lead to more reliance on the income approach or the cost approach.

The income approach generates an indication of the fair value of an asset based on the cash flow that an asset is projected to generate over its useful economic life ("UEL"). The income approach is often applied through the discounted cash flow ("DCF") method.

A fair value measurement using the DCF method is based on the present value of estimated future cash flow over the expected UEL of the asset (or business) discounted at a rate of return that incorporates the relative risk of realizing that cash flow as well as the time value of money.

The DCF method is often applied in estimating the business enterprise value of the acquired company. In the event of a bargain purchase, the enterprise value exceeds the price paid for the business. This relationship gives rise to important considerations for the analyst.

One such consideration is the analysis and reconciliation of the weighted average cost of capital ("WACC"), weighted average return on assets ("WARA"), and the internal rate of return ("IRR").

The WACC is calculated as the required rate of return on the investment in the acquired company by a market participant. It is generally comprised of (1) an after-tax required rate of return on equity and (2) an after-tax rate of return on debt.

The WACC is often an important component in applying the DCF method, as it is typically used to determine the present value of expected future cash flow.

It may be necessary to estimate the WACC before establishing the stratification of the rates of return for the acquired assets. Determining the WARA allows the analyst to compare this figure to the WACC and assess the reasonableness of the required return on assets and the return required by suppliers of capital.

The WARA typically results in a similar overall cost of capital as the WACC. This is because the WACC can be viewed as a weighted average of the required rates of return for the individual assets of the acquired company. Essentially, the operations of the acquired company are considered fundamentally equivalent to the combined assets of the acquired company.

In a purchase price allocation for a transaction occurring at or above fair value, it is generally expected that the IRR (based on projections used to value the transaction and the overall purchase price), the WACC, and the WARA are closely aligned.

In the case of a bargain purchase transaction, the IRR typically exceeds the WACC, and the WACC typically exceeds the WARA.

The misalignment between the three measures can potentially be attributed to the absence of goodwill that is often generated under normal market conditions. Goodwill generally has a higher required rate of return than the other acquired assets, which tends to increase the WARA.

For financial accounting purposes, goodwill is generally a residual amount and the rate of return is calculated as an implied rate of return.

Within the context of WARA, the rate of return on goodwill can be estimated by reconciling the

weighted average rates of return of all the identified assets to the WACC of the acquired company.

It is important for the analyst to understand the interrelatedness of the IRR, WACC, and WARA in the context of a bargain purchase transaction. The analyst should be prepared to discuss these three measures and what contributed to the differences between them.

This may be an area of concern for analysts when reconciling the fair value of the bargain purchase transaction, as auditors generally require an explanation of the differences between the three measures.[3]

It is also important for the analyst to carefully consider the environment in which the transaction took place, as the ramifications of improperly classifying a transaction as a bargain purchase can be substantial.

Typically, certain underlying business and economic conditions are present in bargain purchase transactions. These conditions may include signs of financial distress of the target company, shortcomings in the bidding process, and desired divestiture of noncore business segments of the target firm.[4]

The analyst should gain an understanding of why the transaction was consummated below the estimated fair value as part of his or her due diligence. This understanding provides the analyst with important context surrounding how and why the transaction is not occurring at the estimated fair value.

Purchase Price Allocation Examples

Business combinations range from simple to complex, but most transactions contain similar asset structures. In the example presented in Exhibit 1, the acquiring company transferred consideration of $1.2 million for net assets of $1.05 million resulting in $150,000 recorded as goodwill.

Alternatively, the example presented in Exhibit 2 demonstrates a combination where the consideration paid (lowered to $1 million) is less than the estimated fair value of the net assets received. This situation is often referred to as negative goodwill—or a bargain purchase.

In Exhibit 2, the acquiring company will recognize an immediate gain on its income statement of $50,000. The results of a bargain purchase will have financial accounting implications including potential adjustments to total assets, shareholders' equity, taxable income, and net income.

Exhibit 1
Illustrative Business Combination Acquisition Accounting
Transaction Price Indicates Positive Goodwill Amount

	Fair Value
Tangible Assets and Liabilities:	
Cash	$100,000
Net Working Capital	150,000
Tangible Personal Property	400,000
Real Property	300,000
	$950,000
Liabilities Assumed	(100,000)
Identifiable Intangible Assets:	
Patents	125,000
Trademarks	75,000
Fair Value of Assets and Liabilities	1,050,000
Goodwill	150,000
Consideration Transferred (purchase price)	$1,200,000

Securities and Exchange Commission Perspective on Bargain Purchase Transactions

According to the SEC Division of Enforcement, the total number of enforcement actions decreased during fiscal year 2020.[5] Historically, even during times of decreased enforcement, there is evidence that bargain purchases (and other asset valuations) are increasingly scrutinized.[6]

While the SEC does not provide a basis or strategy for its enforcement actions, they may consider bargain purchase transactions as red flags for balance sheet overstatements.

Therefore, buyers (along with accountants and analysts) should scrutinize bargain purchase transactions to avoid complications with the SEC or other financial reporting deficiencies.

In August 2017, the SEC issued an order instituting public administrative and cease and desist proceedings against a national audit firm and one of its partners along with

the relevant entity Miller Energy Resources, Inc. ("Miller").[7]

Miller is a Tennessee corporation located in Knoxville, Tennessee. Specifically, the SEC action noted the following violations:

1. Rule 102E and Section 4C of the Exchange Act
2. Failure to Properly Plan the Audit (AU 331 and 332)
3. Failure to Exercise Due Professional Care and Professional Skepticism (AU 230, 316 and 722)
4. Failure to Properly Test Fair Value Measurements and Disclosures and Using the Work of a Specialist (AU 328, 342 and 336)
5. Failure to Obtain Sufficient Competent Evidential Matter (AU 315 and 326)
6. Failure to Supervise the Engagement Team Properly (AU 311)
7. Failure to Prepare Required Documentation (AS 3)
8. Failure to Issue an Accurate Audit Report (AU 508)
9. Failure to Perform Adequate Personnel Management (QC 20 and 40)
10. Failure Related to Adequate Competency and Proficiency (AU 210 and 161, QC 20)

Exhibit 2
Illustrative Business Combination Acquisition Accounting
Transaction Price Indicates Negative Goodwill Amount

	Fair Value
Tangible Assets and Liabilities:	
Cash	$100,000
Net Working Capital	150,000
Tangible Personal Property	400,000
Real Property	300,000
	$950,000
Liabilities Assumed	(100,000)
Identifiable Intangible Assets:	
Patents	125,000
Trademarks	75,000
Fair Value of Assets and Liabilities	1,050,000
Goodwill (bargain purchase element)	(50,000)
Consideration Transferred (purchase price)	$1,000,000

In 2010, Miller Energy acquired oil and gas interests located in Alaska initially valued at $4.5 million. Miller subsequently inflated the value of the assets to $480 million in its 2010 financial statements, resulting in a bargain purchase gain of $277 million.

In March 2016, Miller and its subsidiaries filed a voluntary petition for Chapter 11 reorganization and cancelled and extinguished all common and preferred shares.

Prior to the Miller acquisition of the Alaska assets, the former owners tried and failed to sell the oil and gas interests in the open market. These efforts began in late 2008 and ended in mid-2009. Additional attempts to sell the assets via bankruptcy auction also failed. Ultimately, the assets were abandoned.

During 2009, the abandonment was rescinded, and Miller acquired the oil and gas interests for $2.25 million plus the assumption of certain liabilities.

Miller disclosed the value of the assets as $480 million ($368 million for properties and $110 million for fixed assets) and recorded a gain of $277 million in its first SEC Form 10-Q filing following the purchase. At that point in time, the Alaska assets were greater than 95 percent of Miller's assets.

The SEC determined the $368 million value was based on reserve reports that were not suitable for fair value measurement purposes and the $110 million was duplicative. Because of the incorrect fair

value measurements, it was determined that Miller materially misstated the fair value of its assets.

It is evident from the Miller case that the SEC expected more scrutiny from all the parties involved in the transaction (accountants, analysts, and company management). It is also evident that while large bargain purchase transactions are possible, a gain of $277 million on a $4.5 million purchase (more than 61 times) is highly questionable and likely to receive additional scrutiny from the SEC.

Recent Bargain Purchase Transactions

It is likely that several bargain purchases occurred during 2020 as the world continued to grapple with the negative economic effects of the COVID-19 pandemic. Increased economic stress related to the global pandemic may have been a primary cause of several bargain purchases that occurred in the past year.

We identified a number of likely bargain purchases transactions that occurred during 2020. Three of these transactions are discussed below.

Schmitt Industries Acquires Ample Hills Creamery – July 2020

Schmitt Industries ("Schmitt") was founded in 1984 and is a manufacturing company that produces a variety of products, including laser sensors (under the Acuity® brand) and tank monitoring systems (under the Xact® brand).

Schmitt acquired Ample Hills Creamery on July 9, 2020, after placing a bid as part of bankruptcy proceedings in the United States Bankruptcy Court for the Eastern District of New York.

Ample Hills Creamery is based in Brooklyn, New York, and produces ice cream that is sold through its retail stores. Ample Hills Creamery took on a considerable amount of debt in order to open an ice cream manufacturing facility in Brooklyn.

Additionally, Ample Hills Creamery experienced operational difficulties due to the local coronavirus restrictions in place during the first and second quarter of 2020. Ample Hills Creamery filed for bankruptcy in spring 2020 and was purchased by Schmitt.

Schmitt provided total consideration of $1.7 million and acquired identifiable net assets of $2.9 million. Thus, Schmitt reported a gain on bargain purchase of $1.2 million.[8]

Live Ventures, Inc., Acquires Precision Industries, Inc. – July 2020

Live Ventures, Inc. ("Live Ventures"), is a diversified holding company with interests in the flooring manufacturing, steel manufacturing, and retail industries. Live Ventures was founded in 1968 and is based in Las Vegas, Nevada.

Live Ventures acquired Precision Marshall, Inc. ("Precision Marshall"), on July 14, 2020. Precision Marshall is a steel manufacturer located in Pennsylvania.

Live Ventures contributed total consideration of $37.8 million and acquired identifiable net assets of $39.3 million. Live Ventures reported a bargain purchase gain of $1.5 million.[9]

StoneX Group, Inc., Acquires Gain Capital Holdings, Inc. – July 2020

StoneX Group, Inc. ("StoneX Group"), was founded in 1924 and operates as a global financial services network that provides various investment and brokerage services to retail and institutional investors across the world.

In February 2020, StoneX Group entered into a merger

agreement to acquire Gain Capital Holdings, Inc. ("GCH"). GCH is a global provider of trading services to institutional and retail investors. GCH specializes in over-the-counter products and exchange-traded futures.

The merger between StoneX Group and GCH closed on July 30, 2020. At the time of the acquisition, StoneX Group reported that GCH's identifiable net assets acquired were $318.4 million. StoneX Group provided total consideration of $236.6 million and, as a result, recorded a gain on bargain purchase of $81.8 million.

The following quote from the StoneX Group 2020 annual report discusses the potential factors that contributed to the company recognizing a bargain purchase gain from the acquisition of GCH:

> The company believes that the transaction resulted in a bargain purchase gain primarily due to the significant market volatility experienced during the first calendar quarter of 2020, primarily as a result of the COVID-19 pandemic. The market volatility experienced during 2020 through the Gain acquisition date increased significantly compared to corresponding historical periods. This resulted in Gain generating windfall profits and a corresponding increase in net tangible book value.[10]

Summary and Conclusion

Although historically a rare occurrence, business combinations may, in certain situations, result in a bargain purchase. Such transactions give rise to important considerations for the parties involved.

The buyer should be aware of the requirements and the process for identifying assets, liabilities, and consideration transferred. The buyer should also understand the procedures employed by the analyst in measuring the fair value of the assets, liabilities, and consideration transferred.

The analyst should ensure that appropriate methods are employed in the fair value measurement analysis. The analyst should be prepared to discuss and reconcile any potential differences between the WARA, WACC, and IRR.

One concern of the FASB and the SEC is whether the assets and liabilities acquired are appropriately reported at fair value. Bargain purchase transactions may be a red flag for potential asset overstatements.

Finally, failure to understand the implications of a bargain purchase transaction can lead to several pitfalls, including inaccurate financial accounting as well as legal action from the SEC.

"[F]ailure to understand the implications of a bargain purchase transaction can lead to several pitfalls, including inaccurate financial accounting as well as legal action from the SEC."

Notes:

1. Juan Ramirez, *Handbook of Basel III Capital: Enhancing Capital in Practice* (Hoboken, NJ: John Wiley & Sons, 2017), 86.
2. SEC Administrative Proceeding File Number 3-18110.
3. "Application of the Mandatory Performance Framework for the Certified in Entity and Intangible Valuations Credential" (Corporate and Intangibles Valuation Organization, LLC, 2017), 25.
4. Eugene E. Comiskey and Charles W. Mulford, "Changes in Accounting for Negative Goodwill: New Insights into Bargain Purchase Transactions. Why Sell for Less Than Fair Value?" whitepaper, http://hdl.handle.net/1853/39313 (April 2011), 23.
5. SEC Division of Enforcement, 2020 Annual Report (November 2, 2020). There seems to be general agreement of the legal and corporate community that SEC enforcement actions should significantly increase under the new executive branch.
6. David Woodcock, Joan E. McKown, and Henry Klehm III, "SEC Enforcement in Financial Reporting and Disclosure—2017 Year-End Update," Harvard Law School Forum on Corporate Governance, https://corpgov.law.harvard.edu/2018/02/19/sec-enforcement-in-financial-reporting-and-disclosure-2017-year-end-update/ (January 2018).
7. SEC Administrative Proceeding File Number 3-18110 (2017).
8. As of the date of publication, Schmitt has not finalized the purchase price allocation as part of the acquisition of Ample Hills Creamery. As such, the accounting for the transaction (including the gain on bargain purchase) may change.
9. Live Ventures 2020 10-k, p. f-19.
10. StoneX Group Annual Report, 2020, p. 103.

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