Special Report

Goodwill and Bargain Purchases:

The Essentials of Purchase Price Allocation

aranca

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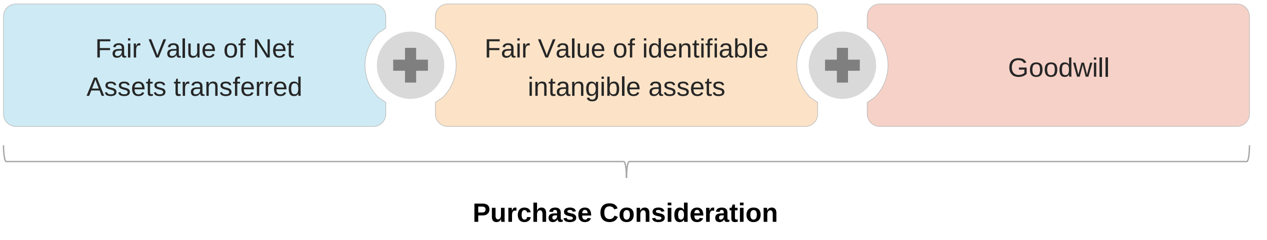
Goodwill and Bargain Purchases

When a company acquires another business, the process involves determining a fair value of the acquired assets (tangible and identifiable intangible assets) and liabilities. This accounting procedure is known as Purchase Price Allocation (PPA), which is a critical step in understanding the true value of a business combination. In PPA, Goodwill and Bargain Purchase are two crucial components that require estimation. This article delves into the concept of Goodwill and Bargain Purchase, their significance, their assessment, and why they play a vital role in financial reporting.

What is Goodwill, and how is it estimated?

Goodwill is an unidentifiable intangible asset with indefinite life, representing the excess purchase price paid over the fair value of the identifiable net assets acquired in a business combination.

Goodwill = Purchase Price - Net Fair Value of Assets/Liabilities



It arises from factors such as brand reputation, customer loyalty, intellectual property, and skilled workforce contributing to the company's future earnings potential. Goodwill is not separately identifiable, and its value is a residual value that can only be derived by subtracting the fair value of net assets and other identified intangibles from the purchase consideration.

What is the importance of Goodwill in PPA?

Goodwill is a key component of the purchase price that reflects the buyer's expectation of future benefits from the acquired business. It represents the synergy and potential advantages the combined entity can achieve and cannot be ascribed to any identifiable intangible asset. It is the resultant figure that is arrived at after allocating the Purchase Consideration to all identifiable assets and liabilities.

An accurate portrayal of Goodwill facilitates companies in rationalizing the Purchase Consideration expended for business acquisitions. It also ensures compliance with accounting standards such as ASC 805 under US GAAP and IFRS 3, which govern the accounting treatment of business combinations. This adherence to regulatory frameworks fosters transparent financial reporting, thereby providing clarity to investors and stakeholders. Further, the accurate representation of Goodwill aids in ensuring compliance with local tax laws, which may permit the amortization of such Goodwill as a deductible tax expenditure. For instance, in Germany, Goodwill typically undergoes amortization over a span of 15 years, while in France, the amortization period spans 5 years. Similarly, Italy allows for amortization over a maximum duration of 18 years, among other jurisdictions.

Goodwill and Bargain Purchases

What is Bargain Purchase and how is it estimated?

While Goodwill represents a premium paid over the fair value of net assets, Bargain Purchase (also known as negative Goodwill) arises when the purchase price is less than the fair value of the acquired entity's net assets. In other words, Bargain Purchase indicates that the buyer acquired the business at a price lower than its book value, creating a gain on acquisition.

Bargain Purchase = Book Value of Assets/Liabilities - Purchase Price

Fair Value of Net Assets transferred + Fair Value of identifiable intangible assets + Bargain Purchase

Purchase Consideration

What is the importance of Bargain Purchase in PPA?

Bargain Purchase might seem like a rare scenario, but it can occur due to distressed sales, economic downturns, or mispriced assets. When Bargain Purchase occurs, it may raise questions about whether the transaction was carried out at fair value. The acquiring company may reap significant benefits from acquiring assets at a discounted price, and this gain is recognized as income on the date of acquisition.

What is the valuers' role in Goodwill recognition or Bargain Purchase?

Valuers are trained professionals with expertise in business valuation techniques. They assess the fair value of the acquired business and its identifiable assets and liabilities in accordance with accounting standards. Valuers identify and separate identifiable intangible assets from Goodwill during the valuation process. This involves analyzing various intangible assets, such as customer relationships, brand value, intellectual property (example: Software), non-compete agreements and workforce, to determine their fair values.

Valuers use various valuation approaches, such as the income approach, market approach, and cost approach, to estimate the fair value of identifiable intangible assets.

Goodwill is then derived as the residual amount after deducting the fair value of identifiable intangible assets and net tangible assets from the total purchase consideration.

Valuers must adhere to relevant accounting standards, such as IFRS or GAAP, while valuing Goodwill. These standards provide guidance on the recognition, measurement, and disclosure of Goodwill in financial statements. Valuers ensure their valuation methodologies align with prescribed accounting principles to produce accurate and compliant valuations.

Moreover, accounting standards require companies to regularly assess the carrying value of Goodwill for impairment. If the carrying value of Goodwill exceeds its recoverable amount, the company must recognize an impairment loss, which can have a significant impact on the financial statements. Hence, accurate estimation of Goodwill during PPA is essential for transparent financial reporting.

Bargain Purchase also warrants scrutiny from accounting regulators, as it could imply errors in the valuation process or signal potential financial reporting issues. For investors and stakeholders, understanding Bargain Purchase is crucial for assessing the deal's true financial impact on the acquiring company and whether it indicates potential undervaluation or hidden risks.

Illustrative Example of Goodwill Recognition

On March 4, 2022, Microsoft acquired Nuance Communications, Inc. for nearly $18.8 billion. Nuance is a renowned leader in the field of conversational AI and cloud-based ambient clinical intelligence, catering specifically to healthcare providers. With this acquisition, Microsoft was expected to further strengthen its presence in the healthcare technology landscape and potentially unlock new possibilities for the advancement of conversational AI and cloud-based intelligence in the healthcare industry.

In this transaction, intangibles accounted for 23% of the total purchase price paid, offsetting 10% from the acquired liabilities of the company. Below, you will find a summary detailing the breakdown of the purchase price paid by Microsoft:

Allocation of Purchase Price	Amount ($ million)		% of total Purchase Price
Total Purchase Price		**18,761**	**100%**
Assets	42		
Liabilities	(1,972)		
Net Tangible Assets/Liabilities taken over		**(1,930)**	**-10%**
Customer related	2,610		
Technology-based	1,540		
Marketing related	215		
Total Identified Intangible assets		**4,365**	**23%**
Goodwill		**16,326**	**87%**

Aranca Observation:

According to the Aranca PPA tool analysis, the median Goodwill as a percentage of total Purchase Price for transactions exceeding $500 million is approximately 58%. In contrast, the acquisition of Nuance Communications by Microsoft shows a significantly higher Goodwill percentage of 87.0%, placing it at the upper end of the benchmark range. This elevated Goodwill ratio suggests a heightened risk of potential impairment if the target's post-acquisition performance falls short of projections. Given this scenario, Microsoft's management may need to proactively conduct impairment testing to ensure a smooth closure of financial statements for the relevant reporting period. This preemptive approach would help address any potential discrepancies and maintain transparency in financial reporting, particularly given the substantial premium paid in the acquisition.

Goodwill and Bargain Purchases

Illustrative Example of Bargain Purchase Recognition

In 2020, First Horizon Corporation acquired IBERIABANK Corporation for $2.5 billion. This acquisition represented a significant consolidation within the banking sector, particularly in the southeastern United States. The acquisition was structured as a stock-for-stock merger, wherein shareholders of IBERIABANK Corporation received a fixed exchange ratio of First Horizon Corporation common stock for each share of IBERIABANK Corporation they owned. While the overall acquisition represented a strategic consolidation aimed at driving growth, enhancing competitiveness, and delivering long-term value to shareholders and customers alike, it concluded at a price that was significantly lower than its previous estimate of $3.92 billion. This reduction was driven by the stock market decline in 2020 associated with the COVID-19 pandemic, thereby resulting in a Bargain Purchase deal. Below is a summary detailing the breakdown of the purchase price paid by First Horizon Corporation:

Allocation of Purchase Price	Amount ($ million)		% of total Purchase Price
Total Purchase Price		**2,502**	100%
Cash	395		
Deposits	1,683		
Securities	3,544		
Loans for sale	320		
Loans and Leases (net of Allowances)	25,637		
Premises and equipment	311		
OREO	9		
Other Assets	1,153		
Total Assets		**33,052**	
Deposits	28,232		
Short-term borrowings	209		
Term borrowings	1,200		
Other liabilities	616		
Total Liabilities		**(30,257)**	
Net Tangible Assets/Liabilities taken over		**2,795**	**112%**
Total Identified Intangible assets		**240**	**10%**
Bargain Purchase (negative Goodwill)		**(533)**	**-21%**

Goodwill and Bargain Purchases

First Horizon Corporation paid $2.5 billion to acquire net tangible assets worth of $3.0 billion, which indicates a negative Goodwill or Bargain Purchase gain of $0.5 billion. In adherence to best accounting practices, both IFRS 3 and ASC 805 require acquirers to disclose the reasons for a Bargain Purchase gain. The accounting treatment is consistent under US GAAP and IFRS, with the gain recognized in the Profit and Loss Account (Income Statement) on the acquisition date. Typically, this gain is classified as "Other Income" or a similar non-operating income category.

Conclusion

Goodwill and Bargain Purchase are integral to understanding the financial dynamics of business combinations within the PPA framework. Goodwill reflects the premium paid for the anticipated future benefits whereas Bargain Purchase represents a gain when the purchase price is lower than the fair value of the acquired net assets. Appropriate estimation and accurate accounting of these components are essential for transparent financial reporting, ensuring compliance with accounting standards such as IFRS 3 and ASC 805. This adherence not only facilitates clear communication with investors and stakeholders but also aids in regulatory compliance and strategic decision-making.

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