**NEED PROFIT? BUY SOMETHING!**

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We first voiced our concern about an obscure accounting rule that allows companies to “create” profits when purchasing other businesses in the “[Curious Case of Miller Energy’s 10-K and Its Huge Bargain Purchase](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/305).” The offending tenet relates to the treatment of something called “negative goodwill” which purportedly is created when a company makes an acquisition, and pays ***less*** than what the assets are worth. This fantastic “bargain purchase” creates a negative goodwill anomaly because the acquirer supposedly gets ***more*** assets than it pays for, as in this example:

|  |  |
| --- | --- |
| Net working capital acquired | $3,125,000 |
| Property, plant, and equipment | 7,200,000 |
| Long-term debt | (1,500,000) |
| Total net assets acquired | 8,825,000 |
| Purchase price | 5,000,000 |
| Negative goodwill  (excess of fair value over cost) | $3,825,000 |

So, what’s the problem? Well, the acquirer now gets to book the entire $3.8 million of negative goodwill into earnings on the date of the transaction! And as we saw in the case of Miller Energy, the profit contribution can be staggering. Hence, our assertion…need profit, buy something!

When Statement of Financial Standards No. 141(R), *Business Combinations*, was issued in December 2007, we simply couldn’t foresee how managers would create an “income opportunity” for themselves from what would initially appear to be such a rare event. Much to our chagrin, more and more companies seem to be availing themselves of this income enhancing “opportunity.”

In addition to Miller Energy, we recently stumbled across examples of bargain purchase gains in 2011 at Under Armour (UA) and Cenveo (CVO). At Under Armour, the Company recorded a $3.3 million gain on the acquisition of $63.8 million in land, building, tenant improvements and third party lease-related intangible assets ([see Annual Report, note 4, pages 56 and 57 for details](http://www.sec.gov/Archives/edgar/data/1336917/000119312512078826/d225054d10k.htm)) for a purchase price of $60.5 million. The purchase price consisted of the assumption of a $38.6 million loan and cash of $21.9 million. Under Armour explained its great fortune in the following way:

*The Company believes that it was able to negotiate the acquisition of the net assets for less than fair value because the seller marketed the property in a limited manner, and thus the property did not have adequate exposure to the market prior to the measurement date to allow for marketing activities that are usual and customary for real estate transactions.*

Ah, we should have guessed…the lazy seller explanation! And if, booking this gain is not enough to make your skin crawl, guess where it was buried in the Company’s income statement? You don’t really have that many choices with Under Armour given the limited P&L detail that the Company provides, but if you had guessed “selling, general and administrative expenses,” you would be correct (see Annual Report page 39). Why there? To get the gain in income from operations, of course. Last time we checked, Under Armour was in the business of selling sports apparel, not buying and selling real estate.

Then, there is the case of [Cenveo](http://www.sec.gov/Archives/edgar/data/920321/000092032112000008/a20111231-10k.htm) which reported a $11.7 million gain on its acquisition of Envelope Product Group, in a year where it recorded a net loss of $8.6 million. Cenveo acquired net assets of $66.9 million for a purchase price of $55.2 million to trigger the “gain.” According to the Company:

*It was able to acquire EPG for less than the fair value of its net assets due to its operating results prior to the Company's acquisition and given its parent company's desire to exit a non-core business.*

Unlike Under Armour, at least Cenveo had the accounting sense to report the “gain” outside of operating income in its own income statement line item.

And the banking industry paid great attention to the details in FASB’s statement, having structured a number of these transactions. Here are some recent examples of banks that participated in this bonanza, as disclosed in recent quarterly reports and earnings announcements:

* [Capital One](http://www.sec.gov/Archives/edgar/data/927628/000119312512216807/d311186d10q.htm) had a bargain purchase gain of $594 million when it acquired ING Direct;
* [Republic Bankcorp](http://www.sec.gov/Archives/edgar/data/921557/000115752312002683/a50265749.htm) enjoyed a gain of $28 million on its purchase of Tennessee Commerce Bank and has expressed an interest in obtaining more bargain purchases of failed banks;
* [Pacific Premier Bancorp](http://markets.on.nytimes.com/research/stocks/news/press_release.asp?docTag=201207190600PR_NEWS_USPRX____LA42922&feedID=600&press_symbol=232682) had a purchase gain of $5 million because of its acquisition of Palm Desert National Bank.

[Aarti Kanjani claims](http://www.snl.com/InteractiveX/Article.aspx?cdid=A-14686138-12075) that since 2010 banks have reported at least $1.6 billion of bargain purchase gains. Indeed, some opportunists are advertising their services for those who would like to take pleasure in these gains.

So, why is this latest “accounting gimmicky” taking hold? Very simply, managers are allowed to set the values of the assets that they buy. If an acquirer believes that the purchased assets are worth more than the amount paid, then management gets to book the difference as a gain. *This is giving us flashbacks to the days of the Savings and Loan Crisis of the 1980’s, when thrifts debited loan assets and credited income from loan fees on speculative real estate development loans!* Of course, we are probably the only ones who remember those days…

The FASB needs to wake up on this issue…it screwed up in allowing the gain to be booked as part of income from continuing operations. In paragraph 36 of SFAS No. 141(R), it acknowledged that bargain purchases were not routine or common, when it used the word “occasionally” to describe their frequency. We believe that “extraordinary gain” treatment would greatly improve transparency for such gains since they clearly meet the “unusual” and “infrequent” criteria. This might also reduce management incentives to play the bargain purchase “game” since any gains would be highlighted as extraordinary, clearly outside of operating income. We would like to point out that this was how the gain was reported prior to SFAS No. 141(R).

Alternatively, maybe the FASB should rethink its indulgence of fair value measurements, especially those not associated with a market value. These measurements allow managers to fulfill their dreams, especially as they are essentially unauditable.

At the risk of boring our readers with a bit of logic and theory, does it really make sense that income can result from simply the purchase of assets, rather than their actual use? Not to us.

And then there is the issue of reporting symmetry. How is it that negative goodwill is immediately recorded as income, but positive goodwill is NOT expensed, but recorded as an asset? GOTCHA! As Walter Schuetze pointed out years ago, goodwill isn’t much of an asset since you cannot sell it (see “[Goodwill Games](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/89)”).

Oh, for the good old days, when income was recorded when it was earned. Well, we are off to the mall to make some bargain purchases (summer sales days are upon us) and generate some income.

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