The Strange Phenomenon of "Negative Goodwill"

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> An article in The Wall Street Journal's *CFO Journal* (*China's Yurun Seeks Investor Goodwill, by Duncan Mavin*) on August 31, 2011 discusses an interesting phenomenon reported by that company, namely that significant portions of its annual earnings over the past five years have flowed from its accounting for business combinations. Specifically, China Yurun has apparently been able to make "bargain acquisitions" each year, which means the prices paid for each transaction have been below the respective fair values of the net assets acquired. Bargain purchases are relative uncommon, for obvious reasons, but when they do occur, today's accounting standards indeed call for immediate gain recognition. The following article explains the reason for this counter-intuitive financial reporting result.

The recent news story about the "negative goodwill" accounting by China Yurun Foods Group may arouse new interest in the arcane accounting concepts of *goodwill* and the less frequently cited *negative goodwill*. As these are often misperceived even by sophisticated preparers and users of financial statements, they deserve explanation.

Under U.S. generally accepted accounting principles (GAAP), international financial reporting standards (IFRS) and most other national financial reporting regimes, when one business is purchased by another, the assets and liabilities acquired and assumed are recorded not at prior carrying amounts, but rather at "fair values." The actual purchase price for the entity being acquired may differ from the net of these fair values to be assigned, and this difference, as a first step, has to be assigned to one or another balance sheet account.

Generally speaking, it is much more likely that the total purchase price exceeds the net amounts assigned to assets and liabilities acquired and assumed, and this premium price differential has long been known as "goodwill" (but more accurately, if less succinctly, is described as "excess of purchase price over fair value of net assets acquired"). The basic assumption is that, when a premium is willingly paid in an arm's-length transaction, this excess represents a valuable if unidentifiable asset being obtained – the synergistic worth of the ongoing business being acquired over the value of the individual parts thereof. The venerable term "goodwill" captures this idea reasonably well.

Sometimes, however, the aggregate price paid is lower than the fair values of the net assets acquired. In such situations, a "bargain purchase" is said to have been achieved – although, again, in arm's-length transactions the ability to make such an advantageous arrangement is infrequently encountered. If a true bargain purchase occurs, there needs to be an accounting treatment prescribed for the "missing credit" after the various assets and liabilities are recorded at their respective fair values. Arising from the opposite of the goodwill scenario, the name "negative goodwill" somehow gained currency as the title for that account.

GAAP historically had insisted that reportable gains could only be generated by operating businesses, or by selling off assets or settling obligations; purchasing a business could therefore not create "day one" recognized gains. Until recent years, the accounting solution to bargain purchases was to offset these "missing credits" against the recorded amounts for the various assets acquired – and thus the "gains" would instead be spread over future years, e.g., via lower annual depreciation charges, as the acquired assets were later used or sold. However, in a major change in thinking, current GAAP and IFRS now require that such so-called "negative goodwill" (a somewhat nonsensical term, actually) arising from bargain purchases be taken into income immediately. Thus, a business making sequential acquisitions, if able to execute these all advantageously, could conceivably have reportable "gains on acquisitions" year after year.

In the real world, of course, the talent or good fortune of being able to engage in multiple arm's-length bargain purchases is rare, and thus reports of such occurrences must be skeptically received. It could well be the case that the assets acquired have been over-valued, or that real liabilities assumed have been under-stated or ignored, thus creating the aura of a bargain when one did not exist, and consequently creating the opportunity for "gain on acquisition" accounting that is illusory. In fact, purchase accounting fraud is a not uncommon occurrence.

One must carefully and objectively review the actual facts and circumstances before rendering such harsh judgment, in all fairness, but the reported availability of innumerable good deals reminds one of the maxim, "if it appears too good to be true, it probably isn't true."

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