Information Quality and Earnings Enhancement of the Bargain Purchase Gain

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A bargain purchase gain arises for the acquiring company when the fair value of the acquired firm exceeds its purchase price. Since 2009, accounting standards require the excess to be immediately recognized as a bargain purchase gain in the acquiring company's results of operations. This study examines such gains of non-financial firms covered by the SEC EDGAR database from 2009 to 2014. Our findings cast doubt on the informativeness of the reported bargain purchase gains and suggest that different companies may engage the bargain purchases for different reasons.

INTRODUCTION

A bargain purchase gain arises for the acquiring company in an acquisition when the fair value of the acquired firm exceeds its purchase price. In such cases, earlier accounting standards required that certain noncurrent assets be written down on a pro rata basis to make up for the difference between the consideration paid and the fair value of the net assets acquired (see, e.g., De Moville and Petrie, 1989, and Comiskey and Mulford, 2007). In December 2007, the Financial Accounting Standards Board (FASB) issued its Standard No. 141R, *Business Combinations*, requiring the acquiring company to record the acquired net assets at fair value. It additionally requires the acquiring company to report the excess of the fair value acquired over the purchase price as a gain from bargain purchase, an income item, immediately. This standard became effective for annual reporting periods beginning on or after December 15, 2008.

The current requirements, to record the net assets acquired at fair value and to recognize a bargain purchase gain when the fair value exceeds the consideration paid, improves previous standards by allowing an acquiring company to reflect its financial position more accurately. The immediate recognition of a bargain purchase gain, however, may not always present a realistic picture or provide useful information about the bargain purchase (Gaharan, 2015). The inclusion of the gain in current income may also provide an acquiring company the opportunity to manipulate its earnings. Considering that during and after the recent financial crisis many acquiring companies were able to purchase financially struggling targets at a bargain, those issues become particularly important. This study empirically examines the information quality of the bargain purchase gain and its potential use for earnings manipulation under current accounting standards.

RESEARCH QUESTIONS

Comiskey and Mulford (2011) categorize the self-documented reasons that an acquiring company reports a bargain purchase gain as follows: 1) financial distress of target firm, 2) tax benefits available to acquiring firm, 3) characteristics of the acquiring firm, 4) flaws in the bidding process, 5) changes in business strategy of target firm, 6) nature of the business of target firm, and 7) special factor (support of workforce employment). The authors posit that categories 1 and 2 reasons "could raise questions about the target's future financial success or the ultimate ability of the acquiring firm to successfully integrate the target's business." Categories 3 and 4 reasons "relate more to price than to quality and are less likely to call into question the future operating success of the target's business" than do categories 1 and 2 reasons. The effects of categories 5, 6, and 7 reasons on the acquiring company, nonetheless, remain uncertain.

Motivated by Comiskey and Mulford (2011), we formulate our first research question as follows:

Q1. Is the bargain purchase gain a reliable indicator that the acquisition is a benefit to the acquiring company?

For some bargain purchases, the acquiring company may indeed benefit from the acquisition, and thus, the gain recognition conveys reliable information to financial statement users. On the other hand, a financially distressed target could be in such a poor state that its financial position can be improved only through considerable cost to the acquiring company. In the latter case, the immediate recognition of a gain does not indicate a benefit to the acquiring company in an economic sense. Accordingly, our first research question investigates the quality of information provided by the bargain purchase gain.

Q2. Do companies exhibit a tendency to use the bargain purchase gain to improve their earnings image?

Our second research question explores the possibility that an acquiring company may use the recognition of a bargain purchase gain to bolster its earnings image. Specifically, the immediate recognition of the bargain purchase gain allows an acquiring company an immediate improvement in its earnings as well as access to the net assets acquired. Consequently, the acquisition of a target to produce an enhanced earnings image through including the bargain gain in income may become a higher-ranking goal for the acquiring company than the assurance that the acquired firm will be capable of producing successful operations in the future.

Additionally, a company may rely on the recognition of the bargain purchase gain either to avoid reporting a loss or to maintain an upward earnings stream. We examine these two possibilities separately in our second research question.

DATA AND DESIGN

We hand-collected data on all companies that had completed acquisitions with bargain purchase gains in fiscal years 2009 to 2014 from the SEC EDGAR database. Table 1 summarizes the number of companies that reported bargain purchase gains by year:

TABLE 1
NUMBER OF COMPANIES REPORTING BARGAIN PURCHASE GAINS BY YEAR

Fiscal Year	All	Financial Companies	Non-financial Companies
2009	65	35	30
2010	35	18	17
2011	77	40	37
2012	64	32	32
2013	48	22	26
2014	41	21	20
Total	330	168	162

Table 1 shows 330 acquiring companies reporting bargain purchase gains from 2009 to 2014. Each of the 330 observations indicates an acquiring company completing one or more acquisitions in a given year, and the same acquiring company completing several acquisitions in different years is counted as individual observations in the specific years.

Of the 330 acquiring companies, 168 are financial companies such as banks (122) and companies in investment services, insurance, and real estate services (46). Because of the economic problems with the finance industry during the sample period, bank acquisitions were often aided by the Federal Deposit Insurance Corporation (FDIC) (Janson, 2009). The number of bargain purchase acquisitions completed by individual banks also far exceeded bargain purchase acquisitions of individual companies in any other industry. Due to those unique aspects, we exclude financial companies and analyze non-financial companies only in this study.

Table 2 shows the number of non-financial companies reporting bargain purchase gains by industry. Most of the 140 different companies that completed at least one acquisition with a bargain purchase gain are in the manufacturing industry (76), followed by the services industry (19). In total, those 140 companies completed 176 bargain purchases over the six-year period from 2009 to 2014.

TABLE 2
NUMBER OF NON-FINANCIAL COMPANIES REPORTING BARGAIN PURCHASE GAINS BY INDUSTRY

Industry	Companies
Agriculture, Forestry and Fishing	1
Construction	5
Manufacturing	78
Mining	7
Retail Trade	4
Services	19
Transportation, Communications, Electric, Gas and Sanitary Services	16
Wholesale Trade	10
Total	140

After identifying all non-financial companies that report at least one bargain purchase, we examined the financial statements of each company to find the amount of the bargain purchase gain as well as other information including its reported income/loss for the year and for the previous year. We also analyzed the notes to the financial statements of each company reporting a bargain purchase gain to determine how many acquisitions were involved and to establish whether the recorded gain was indeed a result of a bargain purchase during that year. We further collected data including amounts, if any, of operating losses and restructuring charges incurred during the year of purchase.

To address our first research question, we analyzed the acquiring companies' financial statements for up to three years after the purchase to discover the fate of each acquired firm after the bargain purchase. Because of the *ex post* data requirement, we examined only acquisitions completed in fiscal years 2009 to 2013. We identified from the financial statements the profitability of an acquisition, any additional losses or costs incurred because of the acquisition, whether the acquisition had been disposed of, and if so, the amount of gain or loss from the disposition. Nonetheless, the *ex post* information subsequent to the bargain purchase is not always available. Some of the acquired firms were absorbed into the acquiring company with no further information regarding the acquisition being provided. In other cases the acquiring company simply did not furnish additional information on the bargain purchase. Moreover, several of the acquiring companies were themselves acquired. Some failed, or for various reasons did not file financial statements after the year of the bargain purchase. These data constraints represent a limit to our analysis.

To address our second research question, we investigated how the prior-year financial position of an acquiring company affects its decision to engage the bargain purchase. Specifically, we examined the relation between prior-year net income and current-year net income, conditional on the acquiring company reporting a bargain purchase gain. Since an acquiring company may rely on the recognition of the bargain purchase gain either to avoid reporting a loss or to maintain an upward earnings stream, we examined those two possibilities separately by the company's prior-year financial position.

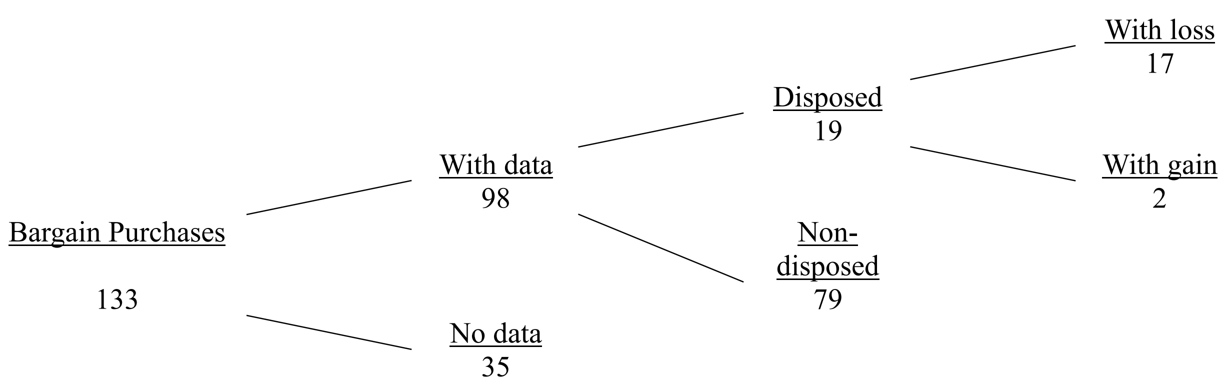
EMPIRICAL RESULTS

Q1. Is the bargain purchase gain a reliable indicator that the acquisition is a benefit to the acquiring company?

We first determined the number of bargain purchases that were followed by associated restructuring charges, other costs, and/or operating losses within one year after the bargain purchase from 2009 to 2013. We excluded bargain purchases in fiscal year 2014 because of the lack of complete financial statement data for 2015. There are 142 bargain purchases from 2009 to 2013, of which 25 (17.61%) are followed by associated restructuring charges, other costs, and/or operating losses.

Table 3 shows the number and disposals of bargain purchases identified from 2009 to 2012. The bargain purchases identified in years 2013 and 2014 are not included because our *ex post* data requirement.

TABLE 3
NUMBER AND DISPOSALS OF BARGAIN PURCHASES IDENTIFIED 2009-2012



From 2009 to 2012, there are 133 separate acquisitions that result in a bargain purchase gain. Of those, 35 bargain purchases have no further information available in years after the purchase. The remaining 98 bargain purchases include 19 (19.39%) which were disposed of within three years. From these 19 disposals, 17 are at a loss, often after the acquiring company incurred restructuring charges and operating losses related to the bargain acquisition. The remaining two disposals are with a gain.

These findings collectively suggest that acquiring companies reporting bargain purchase gains do not always benefit from such purchases. In a nontrivial number of cases, the acquiring company incurred restructuring charges, other costs, and/or operating losses immediately following the purchase. Those costs often far exceed the reported gain from bargain purchase, resulting in the bargain purchase becoming a financial drain to the acquiring company rather than a benefit. The evidence from the disposal of the bargain purchases also reveals that a nontrivial number of disposals were made at a loss, again indicating that a bargain purchase could be a financial burden instead of a benefit to the acquiring company. The questionable quality of the bargain purchase gains we document here is further in line with the empirical findings of both Gaharan (2015) in which costs and losses are associated with a particular bargain purchase as well as Comiskey, Clarke, and Mulford (2010) that the market does not value the negative goodwill reported by acquiring companies in the pre-FAS 141R period.

Q2. Do companies exhibit a tendency to use the bargain purchase gain to improve their earnings image?

Table 4 shows the relationships between the prior-year financial position of acquiring companies reporting a bargain purchase gain and the effects of the bargain purchase gains on current-year net income. The sample includes 162 company-years, of which 56 (34.57%) report a prior-year net loss and 106 (65.43%) report a positive prior-year net income.

TABLE 4
PRIOR-YEAR FINANCIAL POSITION AND BARGAIN PURCHASES

	All	With prior-year net loss	With prior-year positive net income	Significance of difference
Reporting bargain purchase gains	162	56	106	
	Without the bargain purchase gain			
Would report a current-year net loss	19	10 (17.86%)	9 (8.49%)	*
Would report a decreasing current-year net income	93	25 (44.64%)	68 (64.15%)	**

**: Significant at the 5% level.
*: Significant at the 10% level.

Without the bargain purchase gain, 19 of the 108 acquiring companies that report a positive current-year net income would have reported a current-year net loss, which include 10 or 17.86% of the 56 acquiring companies that report a prior-year net loss, and 9 or 8.49% of 106 the acquiring companies that report a positive prior-year net income. The proportions of 17.86% and 8.49% are significantly different at the 10% level. This finding suggests that acquiring companies with prior-year net losses are significantly more likely than those with positive prior-year net income to engage bargain purchases in order to report a positive current-year net income.

In addition, 93 of the 162 acquiring companies would have reported a decrease in income from the prior year to the current year without the bargain purchase gain. Of the 56 acquiring companies with prior-year net losses, 25 or 44.64% would have decreased income without the gain. Of the 106 acquiring companies with positive prior-year net income, 68 or 64.15% would have decreased income without the gain. The proportions of 44.64% and 64.15% are significantly different at the 5% level. This finding suggests that acquiring companies with positive prior-year net income are significantly more likely than those with prior-year net losses to engage bargain purchase gains in order to maintain an upward earnings stream.

Collectively, our results on the second research question suggest that the immediate recognition of a bargain purchase gain provides an acquiring company the opportunity to manipulate its earnings. In particular, companies in different financial positions engage the bargain purchases for different reasons: Acquiring companies with prior-year net losses are more likely to engage the bargain purchases to report a positive net income, and acquiring companies with positive prior-year net income are more likely to engage the bargain purchases to maintain an upwards earnings stream.

CONCLUSIONS

Although the FASB has improved reporting standards with respect to the acquisition of a company at a bargain, room for additional improvement exists. We find that for a nontrivial number of acquiring companies reporting bargain purchase gains, the immediate recognition of the gain in income does not indicate economic benefits to the acquiring companies: The bargain purchases were followed by associated restructuring charges, other costs, and/or operating losses. Similarly, a nontrivial number of the bargain purchases were disposed at a loss within three years of the purchases.

Moreover, we find that acquiring companies in different financial positions engage the bargain purchases for different reasons, suggesting the likelihood of companies using the bargain purchase gains for earnings enhancements. Specifically, acquiring companies with prior-year net losses are more likely to engage the bargain purchases to report a positive net income, and acquiring companies with positive prior-year net income are more likely to engage the bargain purchases to maintain an upward earnings stream.

Our results collectively highlight some problems that have been predicted in the literature with the current reporting standards, and suggest the possibilities of additional reporting mandates. For instance, our finding that the financial position of a company affects its motive to engage the bargain purchase may imply that further disclosure is in order. Alternatively, reporting rules that aim to capture the essence of the bargain purchase may be appropriate. We leave those directions for future research.

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