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Negative Goodwill: Issues of Financial Reporting and Analysis Under Current and Proposed Guidelines

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EXECUTIVE SUMMARY

Under current GAAP, initial bargain-purchase amounts, also known as negative goodwill (NGW) or the excess of the fair value of acquired net assets over the cost of an acquisition, are typically reduced or eliminated altogether by being allocated against the fair values of certain acquired assets such as property, plant and equipment and intangible assets. Any negative goodwill that is not offset against these assets is reported in the income statement as an extraordinary gain. However, in a joint effort with the International Accounting Standards Board (IASB), the Financial Accounting Standards Board (FASB) has developed a replacement for current GAAP, which, among other things, requires that all NGW, without offset, is to be immediately recognized as a gain.

This report outlines the current and proposed accounting treatment of negative goodwill and their impact upon financial statements as well as their implications for financial analysis. For a sample of companies, we find material increases in assets, shareholders' equity and net income under the proposed new treatment.

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Georgia Tech Financial Analysis Lab

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Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Companies Included in this Research Project

Introduction

Goodwill is recorded when an acquiring firm pays more than the fair value of the identifiable net assets (assets minus liabilities) of an acquired firm. This asset is recorded on the balance sheet of the acquiring firm and is not amortized but is monitored for impairment on an ongoing basis. While goodwill is the result of acquiring a firm at a premium, initial negative goodwill (NGW) results when a firm is purchased for less than the fair value of its net assets.[1] Given the pervasiveness of efficient markets, as well as the old bromide that there are no free lunches, accountants have long been reluctant to record these bargain-purchase amounts as assets. Initial NGW has often been viewed as simply the result of overvaluations of acquired assets or of unrecorded obligations or unrecognized future losses. As is illustrated in this report, current GAAP follows something of a middle ground that frequently rejects the recognition of some but not all NGW. The proposed new GAAP, a replacement for SFAS No. 141, will change current GAAP dramatically by no longer allocating initial NGW to reduce, in some cases to zero, the fair value of certain acquired assets.[2] In this report we examine accounting practices for negative goodwill under current and proposed standards and highlight their implications for financial analysis.

Current GAAP for Negative-Goodwill

SFAS No. 141, *Business Combinations*, generally does not permit the recognition of initial NGW as a gain. Rather initial NGW must first be allocated to selected assets, reducing their recorded amounts, that are typically considered the most likely to be overvalued.[3] A key paragraph in SFAS No. 141 outlines this process:

> "In some cases, the sum of the amounts assigned to assets acquired and liabilities assumed will exceed the cost of the acquired entity (*excess over cost or excess*). That excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefits, and (e) any other current assets."[4]

The assets from (a) to (e) above are those that are less likely to be overvalued. That is, they present less of a challenge in developing reasonable estimates of fair value. Most other assets or

[1] The term, *initial* NGW, is used to distinguish NGW recorded at the time of an acquisition from the residual NGW, if any, after allocations have been made to reduce the carrying value of selected acquired assets. It is common practice for NGW to be the label applied to each of these amounts. Where it seems to be useful or important, we will use the word *initial* as a prefix to NGW when none has yet been allocated and the prefix *residual* where the initial NGW has already been allocated.

[2] SFAS No. 141, *Business Combinations*, (Norwalk, CT: Financial Accounting Standards Board, 2001). The Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Business Combinations, a replacement of FASB Statement No. 141*) is dated June 30, 2005. The planned issue date of the final Statement is late 2007. The effective date is to be for years beginning after December 15, 2008. Note that the proposed statement ***prohibits*** companies from adopting the new standard before its effective date.

[3] SFAS No. 157, *Fair Value Measurements*, (Norwalk, CT: Financial Accounting Standards Board, 2006) should make useful contributions to the general issue of fair-value measurement in accounting. The Statement ". . . defines fair value, establishes a framework for measuring fair value in generally accepted principles, and expands disclosures about fair value measurements."

[4] SFAS No. 141, *Business Combinations*, (Norwalk, CT: Financial Accounting Standards Board, 2001), para. 44.

so-called *allocation* assets fall into the categories of intangibles, property, plant and equipment, and other non-monetary and non-current assets. These assets are viewed as presenting greater valuation challenges and therefore are more likely to be overvalued.

In what is probably the most common NGW case, the amount of the initial NGW will be exceeded by the fair value of the assets that are the targets of the NGW allocations (all assets with the exception of those from (a) to (e) above or the *allocation* assets). In this case, initial NGW will be fully allocated to reduce the fair value of the allocation assets. The next most common circumstance is for the initial NGW to exceed the allocation assets. In this case, SFAS No. 141 calls for the residual or unallocated NGW to be reported as an extraordinary gain. This treatment is outlined in the quotation below from SFAS No. 141:

> "If any excess remains after reducing to zero the amounts that otherwise would have been assigned to those (the allocation) assets, the remaining excess shall be recognized as an extraordinary gain . . ."[5]

Prior to SFAS No. 141, the GAAP treatment for the above example was provided by Accounting Principles Board (APB) Opinion No. 16. The key difference was that APB No. 16 required the *remaining excess* to be amortized into earnings over the future years that were expected to be benefited and not recognized immediately as an extraordinary gain.[6]

In what is probably the least common circumstance, there is initial NGW but no allocation assets. In such a case, all of the NGW is recognized as an extraordinary gain. These three cases are summarized in Exhibit 1.

Exhibit 1: Alternative Initial Negative Goodwill Conditions under SFAS No. 141

Relationship of negative goodwill to the fair value of allocation assets	Allocation of negative goodwill: balance sheet and income statement effects
Case (1): Negative goodwill is equal to or less than the fair value of the allocation assets.	(a) Allocation assets are reduced by the full amount of the initial NGW. There is no residual NGW. (b) No extraordinary gain is recognized.
Case (2): Negative goodwill exceeds the fair value of the allocation assets.	(a) Allocation assets are reduced to zero. (b) The residual NGW is recognized as an extraordinary gain.
Case (3): Negative goodwill but no allocation assets	(a) In the absence of allocation assets, no initial NGW is allocated. (b) All of the NGW is recognized as an extraordinary gain.

[5] SFAS No. 141, para. 45.
[6] APB No. 16, *Business Combinations*, (New York: American Institute of Certified Public Accountants, 1970), paras. 91 and 92.

Case (3) above parallels the results obtained from the application of the new treatment of initial NGW when the original SFAS No. 141 is replaced. That is, the entire excess of the net fair value of the assets acquired over the purchase price will be recognized as a gain. None of the initial NGW will be allocated to the reduction of any of the acquired assets.[7]

Examples of Accounting for Negative Goodwill under Current GAAP

The range of examples of how negative goodwill can be allocated is summarized in Exhibit 1 above. This conceptual overview is now brought to life by actual case examples presented in the same order as they appear in Exhibit 1. At the end of each of these sets of examples, the current accounting under SFAS No. 141 is contrasted with results if the prospective replacement for SFAS No. 141 is applied. In addition, some of the differential implications for financial analysis are identified.

Case (1) Examples: Negative Goodwill Is Equal To or Less Than The Allocation Assets

AIDA Pharmaceuticals, Inc., December 31, 2006 10-K Report, p. F-37

"On August 6, 2006, the Company purchased a 77.5% interest in Qiaer for $2,943,594. Thereafter, Qiaer became a 77.5% owned subsidiary of the Company and the financial results of Qiaer have been consolidated in the accompanying consolidated financial statements of the Company."

The following summarizes the Qiaer acquisition:[8]

Fair value of assets acquired	$15,441,121
Fair value of liabilities assumed	(143,530)
Fair value of net assets acquired	15,297,591
Total consideration paid	(2,943,594)
Initial negative goodwill	12,353,997
Negative goodwill applied to allocation assets	(12,353,997)
Residual negative goodwill	$ -0-

AIDA Pharmaceuticals allocated all of the above initial NGW to reduce the fair value the patents of the acquired firm. The patents, as intangible assets, are a greater challenge to value than many other assets. This is why they were included among the *allocation* assets and their carrying value was sharply reduced in this case by absorbing all of the initial NGW listed above. If AIDA had other allocation assets, then the initial NGW would have been allocated to these assets as well based upon their relative fair values. The absence of the recognition of an extraordinary gain in the AIDA case is consistent with the initial NGW of $12,353,997 being less than the total fair value of all of AIDA's allocation assets. To make the above as clear as possible, the steps required to record the acquisition and allocate the initial NGW are summarized below (arrows are added to clarify the effects of the journal entries):

[7] Proposed Statement of Financial Accounting Standards, *Business Combinations—a replacement of FASB Statement No. 141*, (Norwalk, CT: Financial Accounting Standards Board, 2005) paras. 59-61. Note that the proposed standard does not stipulate that the gain recognized should be classified as an extraordinary gain.

[8] For greater clarity, the original presentation of these data by AIDA Pharmaceuticals has been rearranged somewhat.

Initial recording of the acquisition	Debit	Credit
Fair value of net assets acquired↑	15,297,591	
Total consideration paid↓		2,943,594
Initial negative goodwill↑		12,353,997
Allocation of negative goodwill		
Initial negative goodwill↓	12,353,997	
Patents↓		12,353,997

The effect of the above is that the net assets of AIDA Pharmaceuticals did not increase by the excess of the fair value of the net assets acquired over cost of $12,353,997 ($15,297,591 - $2,943,594). Rather, there was no change in net assets because the investment of $2,943,594 was offset by the reduction in cash paid for the acquisition in the same amount. This will not be the net result in the case of initial NGW cases (2) and (3) in Exhibit 1.

American Oriental Bioengineering, Inc., December 31, 2006 10-K Report, p. F-19

"On July 26, 2006, the Company signed a legally-binding acquisition agreement ("Acquisition agreement") to acquire Heilongjiang Qitai Pharmaceutical Limited ("HQPL"), a Chinese distributor of pharmaceutical products. The Company paid $4.0 million cash to acquire 100% ownership of HQPL. HQPL owns a pharmaceutical retail distribution license and a HQPL Chinese herbal and medicinal material wholesale exchange which is Good Service Practice ("GSP") certified. HQPL's pharmaceutical wholesale and retail network covers the entire country of China, and the Company is utilizing HQPL's network to exclusively distribute the Company's products."

"At the closing, HQPL had no liabilities but had $16,693 in cash and $4,532,391 of fixed assets at fair value that were valued by an independent third party. With the total acquisition cost of $4.0 million, *negative goodwill* exists after the initial assignment of values to all assets acquired and liabilities assumed. The entire *negative goodwill* was subsequently allocated to decrease the values assigned to fixed assets. The following table shows the allocation of acquisition cost to the net assets acquired based on their estimated fair values:"

Total cash consideration	$4,000,000
Total fair value of assets acquired	(4,549,084)
Fair value of liabilities assumed	-0-
Negative goodwill	$ (549,084)
Fair value of fixed assets acquired	$4,532,391
Negative goodwill applied to fixed assets	(549,084)
Adjusted basis of fixed assets	$3,983,307

While not stated as the case, the application of the initial negative goodwill only to the fixed assets would suggest that there were no other allocation assets. As with AIDA above, no extraordinary gain was recognized since all of the initial negative goodwill was allocated to reduce the fair value of the acquired fixed assets. There was no residual goodwill to recognize as an extraordinary gain.

Claymont Steel Holdings, December 31, 2006, 10-K Report, p. 53

"On June 10, 2005, 100% of the outstanding shares of preferred and common stock of Claymont Steel, Inc. (formerly CitiSteel USA, Inc.) and subsidiary (a wholly owned subsidiary of CITIC USA Holding, Inc.) were acquired for $74,400,000 plus working capital and other adjustments by H.I.G. Steel Co, Inc., an affiliate of H.I.G. Capital, LLC, a private equity firm focused on management buyouts and recapitalizations of leading middle market companies as well as growth capital investments.[9] The aggregate purchase price was $105,477,000, which included the $74,400,000 paid to CITIC USA Holding, Inc., a working capital adjustment of $19,247,000 and $11,830,000 of acquisition-related costs. The following table summarizes the allocation of the purchase price based on the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition."

	(in thousands)
Current assets	$108,517
Property, plant, and equipment	9,578
Intangible assets	7,563
Total assets acquired	125,658
Current liabilities	(13,240)
Deferred taxes	(4,643)
Accrued pension	(2,298)
Total liabilities assumed	(20,181)
Net assets acquired (after allocation of initial NGW)	$105,477

"Of the $7,563,000 of acquired intangible assets, $600,000 was assigned to the trade name which is not subject to amortization. This $600,000 was written-off in the third quarter of 2006 when the Company changed its name to Claymont Steel. The remaining $6,963,000 of acquired intangible assets relates to customer relationships and has a weighted-average useful life of approximately five years. The difference between the aggregate purchase price and the estimated fair values of the assets acquired and liabilities assumed was approximately $103,204,000. This negative goodwill was used to reduce the value of property, plant and equipment and intangible assets."

As with AIDA Pharmaceuticals, the treatment of the initial NGW in the Claymont case can be illuminated by outlining how the acquisition is recorded. First, it is important to identify the *initial* fair value of the net assets that were acquired. While not disclosed directly above, the fair value of the net assets can be computed as the cost of the net assets acquired, $105,477,000, plus the disclosed difference of $103,204,000 between the acquisition's cost and the fair value of the net assets acquired, or $208,681,000. The listing above of the net assets acquired represents their fair values *after allocation of the initial NGW*. In summary form, this information is recorded as follows:

[9] H.I.G. Steel subsequently assumed the name of Claymont Steel Holdings.

Initial recording of the acquisition	Debit	Credit
Fair value of net assets acquired↑	208,681,000	
Total consideration paid↓		105,477,000
Initial negative goodwill↑		103,204,000
Allocation of the negative goodwill		
Initial negative goodwill↓	103,204,000	
Property, plant and equipment & intangible assets↓		103,204,000

The result of the above two entries is that the net assets acquired in the acquisition will appear in the consolidated balance sheet of Claymont Steel at their cost of $105,477,000, with none of the NGW being recognized in the income statement or on balance sheet. It should be noted that the combined $17,141,000 assigned to property, plant and equipment and intangible assets represents their fair value minus the allocated initial NGW of $103,204,000.

While not a focus of this report, it should be noted that the proposed replacement of SFAS No. 141 calls for the immediate expensing of acquisition-related costs such as the $11,830,000 included as part of the cost of the Claymont acquisition. Under current GAAP (SFAS No. 141) these costs are treated as part of the acquisition cost. Expensing as opposed to capitalizing the acquisition-related costs will increase initial NGW and with it the gain recognized on the acquisition. However, such additional gains will be offset in the acquiring firm's income statement by the expensed acquisition-related costs. Moreover, this new treatment of acquisition-related costs will not change the value of the acquired net assets.[10]

National Beef Packing Co. LLC, August 26, 2006 10-K Report, p. F-15

"The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of the Brawley acquisition, after allocating negative goodwill of approximately $36.6 million to property, plant and equipment and intangible assets."

	(in millions)
Current assets	$46.3
Property, plant & equipment	34.5
Intangibles	2.4
Total assets acquired	83.2
Current liabilities	(13.4)
Long-term debt, including current maturities	(61.3)
Total liabilities assumed	(74.7)
Net assets acquired (after allocation of initial NGW)	$ 8.5

The acquired net assets of $8.5 million represent the cost to National Beef Packing of the Brawley acquisition. Moreover, they also represent the fair values assigned to the acquired assets and assumed liabilities *after* the allocation of the initial NGW to property, plant and equipment and intangible assets. The recording of the acquisition and the associated allocation of the initial NGW is summarized in the entries below. The acquired net assets of $8.5 must be

[10] For more detail see: Proposed Statement of Financial Accounting Standards, *Business Combinations—a replacement of FASB Statement No. 141*, (Norwalk, CT: Financial Accounting Standards Board, 2005), para. 27.

increased by the allocated initial NGW in order to establish the original fair value of the acquired net assets: $8.5 million of acquired net assets plus $36.6 million of initial NGW equals the original fair value of acquired net assets of $45.1 million. The fair value of the net assets acquired is initially recorded at $45.1 million but the fair values are subsequently reduced by the $36.6 million allocation of initial NGW.

<u>Recording the purchase</u>		
Fair value of net assets acquired↑	45.1	
Stock issued↑		8.5
Initial negative goodwill↑		36.6
<u>Allocating the negative goodwill</u>		
Initial negative goodwill↓	36.6	
Property, Plant & equipment & intangibles↓		36.6

Accounting and Financial Analysis Implications: Case (1)

In each of the above examples, assets were recorded at amounts below their fair values as a result of the allocation of the NGW. If the new requirements of the standard that will replace SFAS No. 141 were applied, then total assets of each of these firms would have been greater because the NGW would not have been allocated and assets would therefore be carried at fair value on the balance sheet. These increases range from less than 1% of the total assets of American Oriental Bioengineering to 58% of the total assets of Claymont Steel Holdings. In addition to the balance sheet effect, net income would also be higher by the amount of the allocated NGW. These increases would amount to 850%, 2%, 252%, and 93% for AIDA, American Oriental, Claymont, and National Beef, respectively. The increases in shareholders' equity range from less than 1% for American Oriental Bioengineering to 119% for AIDA Pharmaceuticals. The results are summarized in Exhibit 2 and Exhibit 3. These examples are not presented as being representative of the larger body of firms with negative goodwill, but they do show that the impact of the new standard may be quite dramatic in some cases.

The changes in assets, shareholders' equity, and earnings that will result from the prospective new treatment of negative goodwill have implications for financial analysis. More and larger acquisitions-related gains will be included in earnings. These are clearly nonrecurring and they will not influence the share prices of the acquiring firms to the same extent as a sustainable increase in earnings. In addition, it is important to note that these gains are not supported by any current cash inflow. That is, these new gains, as is true of all NGW-related gains, will be both nonrecurring and non-cash in nature.

On the balance sheet side, the acquired net assets under the new standard will be carried at fair value, whereas current GAAP requires that initial NGW is allocated to reduce the carrying value of acquired assets. This result is documented in the four examples above. To the extent that NGW may be the product in part of asset overvaluations, unrecognized obligations, or expected future losses, balance sheets under new GAAP will overstate balance sheet strength compared to results under the current SFAS 141. Debt to equity ratios will be stronger under the new GAAP treatment of NGW. Lenders should be alert to the influence of the new GAAP on standard measures of credit quality. For example, the gains represented by NGW, none of which will any longer be applied to reduce the carrying value of acquired assets, should be deducted from reported earnings in computations of sustainable earnings and earnings before interest, taxes and depreciation (EBITDA).

Case (2) Examples: Negative Goodwill Exceeds the Allocation Assets

Anesiva, Inc., December 31, 2006, 10-K Report, p. 64

"Under the purchase method of accounting, the total purchase price as shown below was allocated to the Company's net tangible and identifiable intangible assets acquired and liabilities assumed based on their fair values as of December 15, 2006. The allocation of the purchase price associated with certain assets was as follows:"

	(in thousands)
Net tangible assets	$81,562
In process technology—NF-K.B. Decoy	2,710
Assembled workforce[11]	1,610
Negative goodwill	(8,540)
Total preliminary estimated purchase price	$77,342

"In accordance with APB No. 30, any excess of fair value of acquired net assets over purchase price (negative goodwill) is recognized as an extraordinary gain in the period the business combination is completed. The excess is allocated as a pro rata reduction of the amounts that otherwise are assigned to the non-current acquired assets. Any excess remaining after reducing to zero the amounts that otherwise would have been assigned to those assets is recognized as an extraordinary gain."

"The pro rata reduction of non-current tangible and intangible assets acquired was as follows:"

	(in thousands)
Negative goodwill	$(8,540)
In-process technology—NF-K.B. Decoy	2,710
Assembled workforce	1,610
Property and equipment, net	2,495
Excess (residual) negative goodwill—Extraordinary gain	$(1,725)

The NGW of $8,540,000 is allocated to reduce assets by $6,815,000 ($2,710,000 + $1,610,000 + $2,495,000). This allocation leaves residual NGW of $1,725,000 to be recognized as an extraordinary gain.

Buckeye Ventures, Inc., December 31, 2006, 10-K Report, pp. F-11 to F-12

"On September 22, 2005, effective July 31, 2005, BVI acquired 100% of the outstanding stock of Heating & Air Conditioning Services, Inc. ("HACS") for $200,000 cash. HACS, a Delaware corporation incorporated on October 9, 2001, services and installs heating, cooling, and indoor air quality systems for primarily residential customers located in the Brockton, Massachusetts area. The identifiable net assets of HACS at July 31, 2005 (effective date of the acquisition) consisted of:"

[11] SFAS No. 141 generally does not permit an asset for *Assembled Workforce* to be recognized as a separate intangible, p. 78.

Cash and cash equivalents	$73,827
Accounts receivable, net	213,012
Inventory	480,272
Prepaid expenses and other current assets	30,452
Property and equipment, net	41,030
Accounts payable	(324,046)
Accrued expenses payable	(108,539)
Customer deposits and deferred revenue	(50,446)
Identifiable net assets	$355,562

"The negative goodwill of $155,562 (excess of the $355,562 identifiable net assets of HACS over its $200,000 purchase price) was recorded in July 2005 as a $41,030 reduction in property and equipment, net and an $114,532 extraordinary gain."

Children's Place Retail Stores, Inc., January 28, 2006, 10-K Report, p. 58
"This acquisition was accounted for under the purchase method of accounting in accordance with SFAS No. 141, "Business Combinations" ("SFAS 141"). As such, the Company analyzed the fair value of tangible and intangible assets acquired and liabilities assumed, and determined the excess of fair value of net assets acquired over cost. The Company's purchase price allocation is as follows (in thousands):"

	(in thousands)
Acquisition cost:	
Acquisition payment, inclusive of the post-closing true-up	$ 98,611
Transaction costs	6,405
Total acquisition cost	105,016
Fair value of assets acquired and liabilities assumed:	
Inventories	104,212
Prepaid expenses and other assets	29,520
Property and equipment	48,293
Accounts payable and accrued expenses	(17,955)
Leasehold interests and other long-term liabilities	(7,543)
Total fair-value of net assets	156,527
Excess of fair value of net assets acquired over cost	(51,511)
Allocation of excess fair value of net assets acquired over cost to long-lived assets	48,293
Extraordinary gain on the acquisition of DSNA Business	($3,218)
Extraordinary gain on the acquisition of DSNA Business, net of tax	($1,938)

"As the fair value of the acquired assets and liabilities assumed exceeded the acquisition price, in accordance with SFAS 141, the valuation of the long-lived assets acquired was reduced. Accordingly, no basis was assigned to property and equipment or any other long-lived assets and the remaining excess was recorded as an extraordinary gain, net of taxes."

It is worth noting that the listing of acquired assets and assumed liabilities above are prior to the allocation of the initial NGW. Almost all of the initial NGW was allocated against the property and equipment. The $48,293,000 allocation reduced these assets to zero, as the reference immediately above to "no basis was assigned to property and equipment and other long-lived assets" affirms.

Vector Group Ltd. December 31, 2006, 10-K Report, pp. F-69 to F-71
"In connection with the acquisition of the remaining interests in New Valley, Vector estimated the fair value of the assets acquired and the liabilities assumed at the date of acquisition, December 9, 2005. The Company's analysis indicated that the fair value of net assets acquired, net of Vector's stock ownership of New Valley prior to December 9, 2005, totaled $150,543, compared to a fair value of liabilities assumed of $22,212, yielding net assets acquired of $128,331 which were then compared to the New Valley purchase price of $106,900 resulting in a reduction of non-current assets acquired of $14,665 and negative goodwill of $6,766. The following table summarizes the Company's estimates of the fair values of the assets acquired and liabilities assumed in the New Valley acquisition as of December 9, 2005)."

Tangible assets acquired:	**(in thousands)**
Current assets	$106,526
Long-term investments	14,982
Investments in non-consolidated real estate businesses	71,508
Deferred income taxes	70,810
Other assets	3,972
Total tangible assets acquired	267,798
Adjustment to reflect Vector's stock ownership of New Valley prior to the offer and subsequent merger	(115,210)
Liabilities assumed	(14,123)
Deferred tax liability related to acquired long-term investments and non-consolidated real estate business	(10,134)
Total assets acquired in excess of liabilities assumed	128,331
Reduction of non-current assets	(14,665)
Unallocated (negative) goodwill	(6,766)
Total purchase price	$106,900

Note: immaterial discrepancies between the text of the company's description of its accounting for the acquisition and amounts reported in the table were not explained.

The initial NGW based upon the data above is $21,431,000 (fair value of net assets acquired of $128,331,000 minus the purchase price of $106,900,000). The fair value of the New Valley allocation assets was $14,655,000 and this absorbed an equal amount of initial NGW leaving This $6,766,000 of residual (unallocated) goodwill to be reported as an extraordinary gain.

Accounting and Financial Analysis Implications: Case (2)
An extraordinary gain is recognized in each of the above examples. In these examples, unlike those of case (1), the initial NGW exceeded the fair value of the allocation assets. As a result, a residual amount of initial NGW remained that was recognized in the income statement as an extraordinary gain. These gains increased earnings or reduced losses by 5%, 37%, 2%, and 15% for Anesiva, Buckeye Ventures, The Children's Place, and the Vector group, respectively. Under the proposed new GAAP all of the initial NGW would be included in the income statement as a gain. That is, none of the initial NGW would be allocated to reduce the carrying

value of the acquired net assets. Under the new GAAP, the gains recognized would be much higher, increasing net income by up to 71% more in the case of Children's Place, because all of the initial NGW would be recognized as a gain. Please refer to Exhibit 3.

Unlike Case (1), some extraordinary gains are recognized under current GAAP in the case (2) examples. These nonrecurring and non-cash gains reduce somewhat the quality of earnings, both because these gains are not sustainable as well as because they are non-cash. However, this reduction in earnings quality will be even greater under the new GAAP because the nonrecurring gains will be higher.

On the balance sheet, instead of being reduced to zero, under the new GAAP allocation assets will be carried at fair value. Similarly, shareholders' equity will be carried at a higher amount. As a result, as in the case (1) examples, the case (2) firms will appear to carry less leverage and will appear to be of higher credit quality.

Case (3) Examples: No Allocation Assets

Allocation assets consist mainly of non-current assets, with property plant and equipment and intangible assets being the primary items. In some acquisitions no allocation assets are acquired. In this case all of the initial NGW is recognized as an extraordinary item under current GAAP. Such an outcome is identical to the results obtained under the planned replacement for SFAS No. 141. Some examples of case (3) acquisitions are provided below.

Briggs & Straton Corp., July 2, 2005, 10-K Report, p. 28

"On February 11, 2005, Briggs & Stratton Corporation and its subsidiaries, Briggs & Stratton Power Products Group, LLC and Briggs & Stratton Canada, Inc. acquired certain assets of Murray, Inc. and Murray Canada Co. (collectively "Murray") and entered into a transition supply agreement ("TSA"). The TSA gives Briggs & Stratton the right to purchase finished lawn, garden and snow products from Murray for a period up to eighteen months. Briggs & Stratton has reached an agreement with Murray to end the TSA effective September 30, 2005. The cash purchase price was $122.7 million, including direct acquisition costs of $1.8 million.

The Murray acquisition has been accounted for using the purchase method of accounting. The purchase price was allocated on a preliminary basis to identifiable assets acquired and liabilities recognized based upon their estimated fair values. The estimated fair value of the Murray net assets acquired exceeded the acquisition cost by $19.8 million, after all tax considerations, and this amount was recognized as an extraordinary gain.

The following table summarizes the fair value of the assets acquired, liabilities assumed and extraordinary gain recognized at the date of acquisition:"

	(in thousands)
Assets Acquired:	
Accounts receivable, net	$ 78,851
Inventory, net	83,286
Deferred tax asset	3,263
Total assets	165,400
Liabilities recognized:	
Federal and state taxes payable	(13,015)
Rebates	(4,241)
Warranty	(1,850)
TSA obligations	(3,810)
Total liabilities	(22,916)
Net assets	142,484
Cash paid	122,684
Extraordinary gain	$ (19,800)

The extraordinary gain recognized by Briggs & Stratton is equal to the excess of the fair value of the net assets acquired over the cash paid for the Murray acquisition, i.e. the initial NGW. This is consistent with absence of any allocation assets in the acquisition. Note that the acquired assets listed are mainly current assets, i.e., accounts receivable and inventory, which are not allocation assets. In addition, the deferred tax assets are among the non-allocation assets listed earlier.

Concord Camera Corp., July 2, 2005, 10-K Report, pp. F-14 to F-15

"On May 10, 2004, the Company completed the acquisition of Jenimage Europe GmbH ("Jenimage"), a German corporation. Jenimage, based in Jena, Germany, was merged with the Company's subsidiary, Concord Camera GmbH, which is now a distributor and marketer of JENOPTIK branded photographic and imaging products including digital cameras, APS and 35mm cameras, binoculars and accessories. The acquisition expanded the Company's retail sales and distribution business in Germany and other parts of Europe and resulted in the consolidation of certain European operations and departments at our office in Jena, Germany. The acquisition, recorded under the purchase method of accounting, included the purchase of 100% of the outstanding stock of Jenimage plus acquisition costs together totaling approximately $14.5 million in an all cash transaction. The assets acquired and liabilities assumed are recorded at estimated fair market value at the date of acquisition which resulted in an excess of estimated fair value of net assets acquired over cost, or negative goodwill, of $5.8 million, which was recorded as an extraordinary gain. As the negative goodwill is a permanent income tax difference, no income taxes have been provided relating to the extraordinary gain. The components of the purchase price and its allocation are as follows:

	(**in thousands**)
Consideration and Acquisition Costs:	
Cash paid for Jenimage common stock	$13,382
Acquisition costs	1,162
	$14,544
Allocation of purchase price:	
Current assets, including cash of $4,285	$25,499
Liabilities assumed	(5,177)
Excess of estimated fair value of net assets acquired over cost	(5,778)
	$14,544

As with the acquisition of Briggs & Stratton, all of the assets acquired by Concord Camera are current assets and not candidates for the allocation of any of the $5,778,000 of initial NGW. As a result, the total initial NGW is recognized as an extraordinary gain.

North Pointe Holdings, December 31, 2005 10-K Report, p. 74
"North Pointe Casualty was acquired for less than the aggregate fair value of its net assets, which resulted in the recognition of negative goodwill of $2,905,000. The negative goodwill was recognized as an extraordinary item. The following table summarizes the estimated fair value of assets acquired and liabilities assumed at the date of acquisition:"

	(**in thousands**)
Cash and investments	$19,436
Reinsurance recoverables	1,939
Other assets	786
Total assets	22,161
Losses and loss adjustment expenses	(7,882)
Other liabilities	(253)
Total liabilities	(8,135)
Net assets acquired	14,026
Purchase price and acquisition expenses	11,121
Net assets in excess of purchase price—negative goodwill	$ (2,905)

In the above acquisition, there are no allocable assets against which the initial goodwill could be offset. As a result, the entire initial NGW is included in the income statement as an extraordinary gain. Note that almost all of the assets listed for North Point Casualty are cash and investments, which are not allocation assets. Unlike property, plant and equipment, the valuation of their cash and investments should be quite reliable.

Accounting and Financial Analysis Implications: Case (3)

The initial NGW in each of the above three examples is equal to the extraordinary gains recognized. This is because of the absence of allocation assets in each case. With all of the initial NGW recognized as a gain, the influence on both the sustainable character of reported earnings and their cash content may be significant. With no allocation assets, all of the acquired assets remain on the balance sheet of the acquirer at their fair values.

Case (3) examples are representative of the outcomes to be expected with the planned replacement for SFAS No. 141. The quality of reported earnings in the year of the acquisitions will be weakened because of nonrecurring and non-cash gains. Moreover, the balance sheet in both case (3) under current GAAP and the prospective new GAAP includes assets that are reported at their fair values. This result is consistent with the growing support for the incorporation of fair values in financial statements.

Summary

The material above covers three different NGW classifications across 11 acquisitions. Mastering the variety of accounting treatments and cases can be a challenge. Exhibits 2 and 3 are designed to help by summarizing the outcomes under the relevant current and prospective GAAP. Case (3) examples are not included in Exhibits 2 or 3 because the absence of allocation assets yields the same results under both current and prospective GAAP. That is, all of the acquired assets are recorded at their fair values and the total NGW is recognized as income. The focus in Exhibit 2 and Exhibit 3 is on the differences in total assets, shareholders' equity, and net income under the current and prospective GAAP for cases (1) and (2).

In both cases (1) and (2), total assets and shareholders' equity are larger under the new GAAP. This is because in both cases (1) and (2), under current GAAP, NGW is allocated to reduce the recorded fair values of acquired allocation assets. This will not be the case under the prospective new GAAP. All of the NGW under the new standard will simply be recorded as a gain in the income statement, and not be used to write-down the fair values of certain acquired assets. Shareholders equity increases under the new GAAP with NGW recognized as a gain in the income statement, increasing in the end retained earnings, a component of shareholders' equity.

Exhibit 3 shows an increase in net income in each of the examples from cases (1) and (2). In each of these eight cases, under current GAAP, some or all of the NGW is allocated to the reduction in the recorded value of the acquired assets. However, with the new GAAP, all of the NGW will instead be treated as a gain and included in net income. It is notable that the increases in net income under the new GAAP are substantial in most of the cases presented in Exhibit 3.

Exhibit 2: Financial Statement Impact of Current GAAP Versus New GAAP for Negative Goodwill Transactions on Total Assets and Shareholders' Equity: Case (1) and Case (2)*
(dollars in thousands)

Case (1): NGW is equal to or less than the fair value of allocation assets

	Assets			Shareholders Equity**		
	Current	New	% Change	Current	New	% Change
AIDA	$ 53,810	$ 66,164	23%	$ 10,352	$ 22,706	119%
American Oriental	185,274	185,823	<1	156,177	156,726	<1
Claymont Steel	176,971	280,175	58	(30,214)	72,990	N/A
National Beef Packing	757,910	794,510	5	126,593	163,193	29

Case (2): NGW is greater than the fair value of allocation assets

	Assets			Shareholders Equity**		
	Current	New	% Change	Current	New	% Change
Anesiva	$ 95,376	$ 102,191	7%	$ 88,328	$ 95,143	8%
Buckeye Ventures	4,421	4,462	1	4,394	4,435	1
Children's Place	757,320	805,613	6	392,866	421,842	7
Vector Group	603,130	617,795	2	33,403	48,068	44

* Case (3) examples are not included in the Exhibit because the absence of allocation assets yields the same results under current GAAP and new GAAP.

** With one exception, all of the companies in our sample considered any NGW-related extraordinary gain to be a permanent difference between financial-statement income and taxable income, necessitating no adjustment for income taxes. The one exception is Children's Place, where the adjustment to shareholders equity reflects an after-tax adjustment using the company-employed rate of 40%.

N/A Percentage change is not computed because of a deficit in current shareholders' equity

<1 Percentage change is less than 1%

Exhibit 3: Financial Statement Impact of Current Versus New GAAP for Negative Goodwill Transactions on Net Income for Case (1) and Case (2)*
(dollars in thousands)

Case (1): NGW is equal to or less than the fair value of allocation assets

	Current Net Income	Adjusted Net Income**	% Change
AIDA	$ 1,454	$ 13,808	850
American Oriental	29,201	29,750	2
Claymont Steel	40,920	144,124	252
National Beef Packing	39,411	76,011	93

Case (2): NGW is greater than the fair value of allocation assets

	Current Net Income	Adjusted Net Income**	% Change
Anesiva	$(55,567)	(48,752)	12
Buckeye Ventures	(125)	(84)	33
Children's Place	65,575	111,868	71
Vector Group	49,082	63,747	30

* Case (3) examples are not included in the Exhibit because the absence of allocation assets yields the same results under current GAAP and new GAAP.

** With one exception, all of the companies in our sample considered any NGW-related extraordinary gain to be a permanent difference between financial-statement income and taxable income, necessitating no adjustment for income taxes. The one exception is Children's Place, where the adjustment to net income reflects an after-tax amount using the company-employed rate of 40%.

( ) indicates a net loss

Conclusions

The accounting for negative goodwill under SFAS No. 141 has created varying outcomes based upon the relationship between the amounts of initial NGW and the fair values of specified acquired, i.e. allocation, assets. This approach has reflected the view that NGW is of questionable merit. That is, efficient markets should normally preclude the presence of bargain purchases. Therefore, NGW is often held to simply be the product of the overvaluation of acquired assets. Non-current assets such as property, plant and equipment and intangibles are viewed as the most likely to be overvalued. Hence, these assets are the targets of the allocation of initial NGW. The allocations reduce the carrying value of these assets as well as the amount of any residual NGW that is recognized as a gain. From a financial-analysis perspective, the current SFAS No. 141 reduces the presence of nonrecurring and non-cash gains resulting from acquisitions. This is a desirable outcome for those who reject the idea that gains (income) can be produced by the purchase of another company. Moreover, the allocation of initial NGW reduces the likelihood that assets and shareholders' equity will be overvalued on the balance sheet. However, carried to an extreme, the allocation of initial NGW can result in the presence of functional and productive assets that are recorded on the balance sheet at very nominal values, or even zero. This is accounting conservatism carried too far, but it is a potential outcome as illustrated above.

The planned replacement of SFAS No. 141 will, among a number of other things, introduce a dramatic change in the traditional treatment of NGW. There will no longer be initial NGW and residual NGW but only NGW. Acquired assets will be recorded at their estimated fair values and no NGW will be allocated to reduce the carrying value of selected assets. A gain on the acquisition will be recognized in the full amount of the NGW. This new accounting policy and its associated outcomes simplify accounting for NGW and are in line with the continued development of the fair-value theme of the FASB. However, the new policy has important implications for financial analysis, as assets, shareholders' equity and net income will be reported at higher amounts.