Economic Obsolescence in Business Combinations

The Intersection of Business Valuation and Tangible Asset Valuation Experts

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Outline and Discussion Topics

• History of Accounting Codification Related to Bargain Purchase

• Define Goodwill and Bargain Purchase Accounting Issues

• Understand Economic Obsolescence

• Relay Appropriate Methodologies to Calculate Obsolescence

• Understand Impacts on Business Valuation Specialists
History

- **2001: FASB 141**
  - "Negative Goodwill" allocated to assets to eliminate implied bargain gain

- **2008: FASB 141(R) / 2014: ASC 805**
  - Bargain Purchase recognized as part of the acquisition
Goodwill and Bargain Purchase Definitions

• ASC 805: Business Combinations
  30-1 The acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b): a) The aggregate of the following: 1. The consideration transferred measured in accordance with this Section, which generally requires acquisition-date fair value 2. The fair value of any noncontrolling interest in the acquiree 3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree. b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Topic. (FASB, 2014, Accounting Standards Codification, Subtopic 30 of Topic 805, Business Combinations)
Goodwill and **Bargain Purchase** Definitions

• **ASC 805: Business Combinations**

  25-2 Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in paragraph 805-30-30-1(b) exceeds the aggregate of the amounts specified in (a) in that paragraph. If that excess remains after applying the requirements in paragraph 805-30-25-4, the acquirer shall recognize the resulting gain in earnings on the acquisition date. The gain shall be attributed to the acquirer.
Goodwill and **Bargain Purchase** Definitions

The net of the fair value of all identifiable assets and liabilities

The aggregate of:

(1) the total purchase consideration

(2) the FV of any NCI in the acquired company (if applicable)

(3) the acquisition-date FV of the acquirer's previously-held equity interest in the acquired company
Bargain Purchase Rarity

ASC 805: Business Combinations

30-25-4 Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review.
Bargain Purchases Not as Rare as Expected

• In 2011, the Georgia Tech Financial Analysis Lab released the results of a study related to bargain purchases made during 2009 (the first year modern bargain purchase accounting standards were put in place).

• Highlights of the study included:
  • 21 of the total 71 Bargain Purchase transactions (34%) involved FDIC assisted acquisitions of troubled banks (following the financial crisis).
  • Of the remaining 50 transactions, only 19 actually provided a reason, with some context, for the bargain purchase
  • In many cases the "reason" cited for the bargain purchase simply defined a bargain purchase
Bargain Purchase – Possible Examples

**Qualitative**

- Distressed Seller
  - Overleveraged
  - Historical Financial Losses
- Marketability
  - No exposure to broad market / strategic advisors
  - Workforce concerns
  - Less knowledgeable in regards to future prospects than larger acquirer
  - Wind-down of a fund/portfolio

**Quantitative**

- Reconciliation of WACC/WARA/IRR
  - Bargain purchases usually have high IRR (high cash flow, low purchase price)
  - Bargain purchases generally have low WARA (as Goodwill commands the highest rate of return)
  - WACC generally falls between the two as it is a market participant based input.
Valuation Review Items: Bargain Purchases

• Inventory
  • Has the inventory been carried forward at book value? Is there a possible impairment to inventory?

• Fixed Assets
  • Have all forms of depreciation been considered (Physical, Functional and Economic)?
Fair Value – Highest and Best Use

**Fair Value** (ASC 820)

- The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between marketplace participants at the measurement date. (This statement also explains that a fair value measurement of an asset assumes its highest and best use by market participants. Such use would maximize the value of the asset or group of assets within which the asset would be used, regardless of the intended use of the asset by the reporting entity.

**Fair Value In-Use**

- A value assigned to an asset assuming that the asset is sold as part of an ongoing business operation. Further assumes that the asset is sold and consequently operated with the other assets in its group.
Cost Approach - Overview

• The most employed methodology for fixed asset valuations related to business combinations.

• Places emphasis on the cost to replace or reproduce the asset.

• The basic steps of the cost approach are:
  • Estimate the replacement/reproduction cost new.
  • Estimate physical depreciation.
  • *Estimate functional and economic obsolescence, if any.*
  • Conclude the fair value of the asset.
Cost Approach - Depreciation

• **Physical Deterioration** is the loss in value due to wear and tear during operation and exposure to the elements. Physical depreciation may be curable or incurable. It may be estimated on the basis of how much it would cost to repair or replace various components, limited by what an owner would be economically justified in investing.

• **Functional Obsolescence** is the loss of value caused by factors internal to the asset. Such things as inadequacy, excess capacity, excess construction costs, lack of utility or excess operating costs due to technological advances may indicate the existence of functional obsolescence.

• **Economic Obsolescence** is the loss in value caused by factors external to the asset.

• The primary difference between valuation and accounting concepts of depreciation is that appraisal depreciation measures value inferiority, whereas accounting depreciation is a mathematical convention for recovering an asset's cost.

*Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets*
Cost Approach – Economic Obsolescence

- Economic obsolescence results from a number of causes, including:
  - Lack of demand for the product or service;
  - Excess supply of competitive product or service;
  - Changes in the economics of the industry;
  - Changes in the quality of materials, labor, utilities, and transportation services; and/or,
  - Changes in the local economy, including shifting asset use patterns.
Quantifying Economic Obsolescence

• Economic obsolescence should be measured at the lowest identifiable level. Means by which economic obsolescence can be calculated include:
  • Utilization / Inutility Adjustments
  • Asset Specific Cash Flow Adjustments
  • Market Approach
  • Business Enterprise Level Adjustments

• Economic Obsolescence is conceptually applicable only to those assets valued using a cost approach. The market/income approaches consider all forms of obsolescence.

• Orderly Liquidation Value is considered the fair value floor for fixed assets subject to economic obsolescence.
Economic Obsolescence Impacts for Business Valuation Specialists

• Fixed asset values are often a material input to the primary asset of the business valued by BV appraisers using a Multi-Period Excess Earnings Method ("MPEEM")

• Fixed assets often have a substantially lower rate of return than all acquired assets other than working capital, potentially skewing WARA calculations

• The nature of the valuation profession (the segregation of specialists into silos based on asset type / the execution of a project across multiple firms specializing in only one type of valuation) often creates a void through which economic obsolescence issues slip.
Questions and Comments