

FREQUENCY OF AND REASONS FOR BARGAIN PURCHASES – EVIDENCE FROM GERMANY

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Abstract

This study investigates the prevalence of transactions resulting in negative goodwill under IFRS 3 Business Combinations. For a sample of 1,440 firm-year observations of listed German firms for the years 2005 to 2013, we find 96 negative goodwill transactions which give rise to an immediate gain recognized by the acquirer. Besides the fact that “bargain purchases” are not as rare as assumed by the standard setter when developing the current guidance, we document the reasons for the occurrence of negative goodwill. Our findings show that “bargain purchases” indeed account for the single most disclosed reason in our sample. However, alternative reasons such as future restructuring activities or market conditions are together equally likely to explain the existence of negative goodwill. Therefore, our results question whether the current treatment of negative goodwill as an immediate gain is most appropriate.

Keywords: Business Combinations, Negative Goodwill, Bargain Purchase, Badwill, IFRS 3

JEL Classification: M 41

Acknowledgement

We gratefully acknowledge the valuable and constructive support of Tobias Stork genannt Wersborg

1. INTRODUCTION

When introducing the current requirements for the treatment of negative goodwill arising upon the application of the purchase method for accounting of a business combination, the International Accounting Standards Board (IASB) argued that cases in which the acquirer’s interest in the fair value of the net assets acquired exceeds the cost of acquisition are rare phenomena (IFRS 3.BC147, 2004). Accordingly, claims that the accounting for negative good-will under International Financial Reporting Standards (IFRS)¹ is of minor practical relevance can be found in the literature (e.g. Theile and Pawelzik, 2012). However, the fact that the so-called “bargain purchases” have recently been the explicit main focus area of financial reporting institutions such as the German Financial Reporting Enforcement Panel (FREP) indicates that the issue is yet of importance². Moreover, during the recent Post-implementation Review on IFRS 3 Business Combinations (PIR), national standard setters and auditors of Canada, Hong Kong, Japan, Mexico and the United Kingdom argued that negative goodwill is “not as rare as the standard would suggest” or occurs in “ordinary transactions rather than only in anomalous transactions”³.

To date, these claims are only supported by few international studies which indicate that “bargain purchases” are more frequent than expected and have the potential to materially affect the performance conveyed by financial statements (Comiskey et al., 2010; ESMA, 2014). Moreover, normative and practice-oriented publications discuss several theoretically possible reasons for the occurrence of a negative goodwill. The actual prevalence of and the reasons for negative goodwill transactions, however, still constitute an open empirical question.

These gaps in understanding motivate our paper, in which we examine the frequency of and the reasons for the occurrence of transactions resulting in negative goodwill and being recognized as an immediate gain by the acquirer of a business. Covering a period from 2005 to 2013 and a sample of 1,440 firm-year observations of the largest German listed companies, we find negative goodwill transactions to be not as rare as might be expected. Our exploratory analysis further sheds light on the characteristics of the 96 negative goodwill transactions identified with a focus on their impact on the financial performance of the acquiring entity and the question why negative goodwill occurs. Our results indicate that the gains which are almost unanimously recognized in operating income have the potential to materially affect the operating performance of the acquirer. Specifically we find that the operating income increases through the recognition of negative goodwill by 16 percent on average.

Our analysis of the reasons for the occurrence of negative goodwill shows that the typical “lucky buy”, addressed by the IASB as “bargain purchase”,

¹ In this paper, we use the abbreviation IFRS when we refer to the accounting standards developed by the IASB or its predecessor, the International Accounting Standards Committee (IASC) as well as the related SIC/IFRIC interpretations. The standards that were issued by the IASC are called International Accounting Standards (IAS)

² See the “Main Focus Areas” 2012, 2013, 2014 and 2016 available at FREP (2016).

³ See the respective comment letters available at IASB (2014b).

indeed accounts for the most frequently disclosed reason. However, we further find that alternative reasons such as future restructuring activities or market conditions are together equally likely to explain the existence of negative goodwill in our sample. In combination with the frequency and materiality of negative goodwill transactions, that document the relevance of the issue, these results question whether the current treatment of negative goodwill as an immediate gain is always most appropriate.

Our study contributes to the literature on business combinations accounting which only provides limited evidence on bargain purchase transactions (see Boennen and Glaum, 2014). Documenting the frequency as well as the reasons of negative goodwill as provided by the acquirers, we identify fruitful avenues for future research which should further examine the determinants and consequences of bargain purchase transactions. Moreover, our findings are of interest beyond academic literature. Standard setters, especially the IASB which just conducted its Post-implementation Review on IFRS 3, are provided with a detailed analysis of business combinations with negative goodwill that should help in improving future financial reporting and disclosure regulations.

The remainder of this paper is organized as follows: Section 2 describes the conceptual background of the accounting for negative goodwill under IFRS. Section 3 provides empirical evidence on negative goodwill transactions by a review of prior research as well as our examination of the frequency and materiality of such transactions in Germany. Moreover, section 3 contains an analysis of the reasons for the occurrence of negative goodwill. Section 4 outlines avenues for future research opportunities and concludes.

2. CONCEPTUAL BACKGROUND

2.1 Development of Accounting Principles

Each revision of the accounting for business combinations under IFRS also included a substantial revision of the treatment of negative goodwill arising upon the application of the purchase- or acquisition method (Wirth, 2005)⁴ which shows the controversial nature of the issue under consideration. By laying out the development of the accounting standards from 1983 until today, we intend to show how the separate revisions have affected the calculation and recognition of negative goodwill and thus its frequency, materiality and reasons for occurrence. Consequently, the discussion of the revisions and an in-depth understanding of the accounting provisions, especially from 2004 onwards, will lay the groundwork for our further analysis.

2.1.1 Pre-IFRS 3 Accounting for Business Combinations: 1983-2004

⁴ With the introduction of IFRS 3 (2008) the term "purchase method" was substituted by the "acquisition method". Both concepts refer to the separate recognition and measurement of identifiable assets and liabilities at their fair value in the balance sheet of the acquirer in the event of gaining control over the target company. Only when applying the purchase- or acquisition method can a (negative) goodwill arise and be recognized by the acquirer.

The first international standard on Accounting for Business Combinations, International Accounting Standard 22, was issued in 1983. It allowed two methods to account for a business combination, pooling of interests or purchase accounting. With regard to instances in which "the cost of an acquisition is lower than the aggregate fair value of identifiable assets and liabilities acquired" (IAS 22.25, 1983) and the purchase method was applied, the standard allowed the difference "either [to] be treated as deferred income, and recognized in income over the period similar to that considered in paragraph 21 [which described factors to be considered in determining the useful life of goodwill], or allocated over individual depreciable non-monetary assets acquired in proportion to their fair values" (IAS 22.25, 1983).

The initial standard on business combinations accounting was superseded in 1993 (see Camfferman and Zeff, 2007). IAS 22 Business Combinations (1993) generally acknowledged two types of business combinations, the acquisition of one entity by another and a uniting of interests⁵ in which none of the combining entities can be identified as acquirer (IAS 22.Objective, 1993). For "acquisitions" which the standard described as the main type of a business combination, the purchase method was required (IAS 22.18, 1993), i.e. a comparison of the acquisition cost to the fair value of the identifiable assets acquired and liabilities assumed (e.g. IAS 22.28, IAS 22.40, 1993). In case this resulted in negative goodwill, the standard described a proportionate reduction of the fair values of the non-monetary assets acquired as the "Benchmark Treatment".

Any remaining excess of the acquired net assets over the cost of the business combination was required to be treated as deferred income and "should be recognized as income on a systematic basis over a period not exceeding five years unless a longer period, not exceeding twenty years from the date of acquisition, can be justified" (IAS 22.49, 1993). The underlying rationale of reducing the fair values of the non-monetary assets was that those assets were effectively acquired at a discount which would be realized as income subsequent to the transaction, i.e. when the respective assets are sold or used (IAS 22.50, 1993). Alternatively, the total negative goodwill should be treated as deferred income and recognized as income subsequent to the transaction as described above (IAS 22.51, 1993).

In 1998, the standard on business combinations was revised again. IAS 22 Business Combinations (1998) retained the distinction of two types of business combinations. With regard to "acquisitions", it also prescribed the purchase method of accounting (IAS 22.17, 1998). However, with regard to the treatment of negative goodwill, IAS 22 (1998) contained substantial changes. First, the standard required differentiating whether any excess of the fair value of the net assets acquired over the cost of acquisition (negative goodwill) is

⁵ "A uniting of interests is a business combination in which the shareholders of the combining enterprises combine control over the whole, or effectively the whole, of their net assets and operations to achieve a continuing mutual sharing in the risks and benefits attaching to the combined entity such that neither party can be identified as the acquirer" (IAS 22.9, 1993). According to IAS 22.61 (1993), such transactions were accounted for using the pooling of interests method.

related to expected, subsequent losses and expenses that are based on the acquisition plan of the acquirer. To the extent that this was the case, negative goodwill had to be carried forward until the period in which these losses and expenses occurred and recognized as income contemporaneously. The remaining negative goodwill was treated as follows: The amount which did not exceed the total fair value of the identifiable non-monetary assets acquired had to be recognized "on a systematic basis over the remaining weighted average useful life of the identifiable acquired depreciable/amortizable assets" (IAS 22.62(a), 1998). Any remaining negative goodwill had to be recognized as income immediately⁶.

2.1.2 Accounting for Business Combinations under IFRS 3: 2004-Today

The last fundamental step in the development of the accounting for negative goodwill arising upon a business combination under IFRS was taken during the first phase of the IASB's project on business combinations in the beginning of the current century. With the issuance of IFRS 3 Business Combinations in 2004, the IASB eliminated the pooling of interests method and requires the use of the purchase method for any transaction that meets the definition of a business combinations (IFRS 3.IN7(a), IFRS 3.IN9, 2004)⁷. Besides identifying the acquirer, i.e. the entity which obtains control of the acquired entity, the purchase method requires the acquirer to measure the cost of acquisition⁸ (purchase price plus any acquisition-related costs such as professional fees paid to consultants) as well as to recognize the identifiable assets acquired and liabilities assumed⁹ at the acquisition date (IFRS 3.16, 2004). Thereby, the acquired assets and liabilities assumed are generally measured at their fair values (IFRS 3.36, 2004) and any interest of other parties in the acquire (minority/non-

controlling interest) is measured at the respective share of fair value of net assets (IFRS 3.40, 2004).

Comparing (1) the cost of acquisition to (2) the acquirer's interest in the fair value of the net assets acquired results in either goodwill ($1 > 2$) which is recognized as an asset (IFRS 3.51, 2004) or negative goodwill ($2 > 1$). In the latter case, the acquirer is required to perform a reassessment with regard to the identification and valuation of the assets and liabilities recognized as a result of the business combination as well as the cost of acquisition. This reassessment aims to ensure that negative goodwill is not caused by errors. After that reassessment, any remaining negative goodwill is recognized immediately as income (IFRS 3.56, 2004). Importantly, IFRS 3 (2004) does not prescribe a specific line item in the statement of income and, thus, the acquirers' management is given discretion in that respect (Gros, 2005). However, the amount of negative goodwill recognized as a gain as well as the specific line item in the income statement in which it is included have to be disclosed (IFRS 3.67(g), 2004). Moreover, IFRS 3.67(h) (2004) requires firms to describe the nature of any such gain.

In 2008, the second phase of the IASB's business combinations project was completed with a revised version of IFRS 3. IFRS 3 (2008) was to be applied mandatorily to business combinations which were closed in the first annual reporting period starting on or after July 1, 2009 (IFRS 3.64, 2008). It retained the principle that any business combination must be accounted for using the purchase method (IFRS 3.4, 2008) as well as the requirement to recognize any resulting negative goodwill immediately in profit or loss (IFRS 3.34, 2008). The standard also carried forward the requirement to perform a reassessment with regard to the recognition and measurement of the individual components affecting the amount of goodwill before recognizing a gain due to the existence of negative goodwill (IFRS 3.36, 2008). The determination of (negative) goodwill is described in IFRS 3.32 (2008) which requires the acquirer to "recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:

(a) the aggregate of:

(i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value;
(ii) the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and
(iii) 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 IFRS."

Negative goodwill arises in case the amount in (b) exceeds the aggregate of the amounts in (a) above (IFRS 3.34). As in the preceding standard, in general, the acquirer measures the acquired assets and liabilities assumed at their fair values at the acquisition date (IFRS 3.18, 2008)¹⁰. However, as

⁶ For details about the treatment of negative goodwill under IAS 22 (1998) see IAS 22.59-63 (1998).

⁷ According to IFRS 3 (2004).Appendix A, a business combination was defined as "[t]he bringing together of separate entities or businesses into one reporting entity".

⁸ IFRS 3.25 clarifies that a business combination may involve more than one transaction. In this case, the cost of acquisition is the total of the costs of the individual exchange transactions (e.g. share purchases) measured as at each individual exchange date. IFRS 3.58 further states that "each exchange transaction shall be treated separately by the acquirer, using the cost of the transaction and fair value information at the date of each exchange transaction, to determine the amount of any goodwill associated with that transaction. This results in a step-by-step comparison of the cost of the individual investments with the acquirer's interest in the fair values of the acquiree's identifiable assets, liabilities and contingent liabilities at each step".

⁹ In this context, IFRS 3.41 explicitly states that "(a) the acquirer shall recognise liabilities for terminating or reducing the activities of the acquiree as part of allocating the cost of the combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and (b) the acquirer, when allocating the cost of the combination, shall not recognize liabilities for future losses or other costs expected to be incurred as a result of the business combination." See IFRS 3.BC70 (2004) for the IASB's respective reasoning

¹⁰ IFRS 3 (2008) contains explicit guidance regarding exceptions from the principle to measure all assets and liabilities at their acquisition-date fair

compared to IFRS 3 (2004) changes with effects on the amount of (negative) goodwill have been introduced with regard to the components (i) to (iii) above. First, the consideration transferred comprises the assets transferred and any liabilities incurred by the acquirer to the seller as well as any equity interests issued by the acquirer that are all measured at their acquisition-date fair values (IFRS 3.37, 2008). Importantly, unlike the cost of the business combination under IFRS 3 (2004), acquisition-related costs are not included in the consideration transferred which, *ceteris paribus*, reduces goodwill.

Second, in a stepwise acquisition, the acquirer now has to remeasure any equity interest in the acquiree which it held prior to obtaining control at its fair value at the acquisition date and recognize any resulting difference in profit or loss (IFRS 3.42, 2008). This methodological change also potentially leads to a different amount of (negative) goodwill as compared to the previous requirements (see footnote 8). Third, IFRS 3 (2008) introduced an option with regard to the measurement of any non-controlling interests in the acquiree. According to IFRS 3.19 (2008), interests in the investee held by parties other than the acquirer can either be measured at their respective proportionate share of the identifiable net assets of the acquiree or at fair value. As described in IFRS 3.32(a)(ii) (2008) above, the measurement of non-controlling interests has an impact on the resulting (negative) goodwill.

With regard to the disclosure requirements, it is noteworthy that the IASB now requires the disclosure of the reasons for the bargain purchase rather than “the nature of the gain” (see explanation for IFRS 3.67(h) (2004) above). Importantly, the note disclosures regarding the factors giving rise to goodwill or a gain on a bargain purchase have been one of the main focus areas of the German Financial Reporting Enforcement Panel (FREP) in recent years¹¹. Nevertheless, it is an open empirical question how these disclosure requirements were interpreted in practice and whether the substance of the additional information improved since the change.

2.1.3 Post-implementation Review of IFRS 3 (PIR): 2013-2015

From 2013 to 2015, the IASB conducted its so-called Post-implementation Review on IFRS 3 (PIR) in which it aimed to assess the effects of the new accounting standard on financial reporting practice. In a first phase, the standard setter evaluated which areas of the business combinations standard are the main areas to be considered during the second phase of review. The importance of the accounting for negative goodwill has been emphasized by including the topic as an explicit question in the IASB’s formal Request for Information (RfI) which has been open for public comment (see IASB, 2014a). Considering the feedback received, the IASB decided to maintain the current guidance and defer possible further actions until it conducted its 2015 Agenda

Consultation (see IASB, 2015a)¹². Nevertheless, the comment letters received by the IASB contained controversial discussions with recommendations of various alternatives for negative goodwill recognition (see Table 1) that amongst others suggest the return to the previous treatments under IAS 22 (1993) or IAS 22 (1998).

2.2 Reasons for Negative Goodwill

During the development of IFRS 3 (2004), the IASB considered most business combinations as exchange transactions between independent parties that receive the value they sacrifice (IFRS 3.BC146, 2004). Accordingly, the IASB argued that, theoretically, negative goodwill should not occur and assumed such transactions to be rare if the identification and measurement of the cost of acquisition as well as the assets acquired and liabilities assumed are properly performed (IFRS 3.BC147, 2004). For cases in which the fair value of the net assets exceeds the cost of the business combination, the standard setter explicitly mentioned three possible components of this “excess” (IFRS 3.BC148, 2004):

(a) “errors that remain, notwithstanding the reassessment, in recognizing or measuring the fair value of either the cost of the combination or the acquiree’s identifiable assets, liabilities or contingent liabilities.

(b) a requirement in an accounting standard to measure identifiable net assets acquired at an amount that is not fair value, but is treated as though it is fair value for the purpose of allocating the cost of the combination.

(c) a bargain purchase. This might occur, for instance, when the seller of a business wishes to exit from that business for other than economic reasons and is prepared to accept less than its fair value as consideration.”¹³

With regard to the latter, in the revised version of IFRS 3, the IASB states that “[a] bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion” (IFRS 3.35, 2008). It is noteworthy that the immediate recognition of negative goodwill as a gain was generally not supported by respondents to the IASB’s exposure draft prior to issuing IFRS 3 (2004). One of their main objections was based on the view that “any such excess is likely to arise because of expectations of future losses and expenses” (IFRS 3.BC145(a), 2004)¹⁴. The IASB did not agree with this reasoning and argued that such expectations should be reflected in the fair values of the assets acquired and liabilities assumed (IFRS 3.BC149, 2004). Besides the current treatment, the IASB considered two alternative treatments of negative goodwill: (1) a reduction of the values of some of the identified net assets acquired and (2) the separate recognition of a

values, e.g. with regard to deferred tax assets and liabilities (see IFRS 3.24–31, 2008).

¹¹ See the “Main Focus Areas” 2014 and 2016 available at FREP (2016).

¹² For detailed information about the recent PIR on IFRS 3 including the results of the analysis of comment letters in response to the RfI and of a review of related academic research see IASB (2015b).

¹³ See also IFRS 3.57 (2004).

¹⁴ Besides, the opponents of the current treatment of negative goodwill criticized that the immediate recognition in profit or loss would not lead to representationally faithful presentation as far as the “excess” results from measurement errors or measurement bases other than fair values and that the treatment would be inconsistent with the historical cost principle (see IFRS 3.BC145, 2004).

liability in the amount of negative goodwill. Finally, however, the IASB decided that the immediate recognition in profit or loss would be the most representationally faithful method with regard to that part of the excess which is attributable to a bargain purchase, while the amounts attributable to

the components (a) and (b) described above could not be determined separately (see IFRS 3.BC150-156, 2004). Consequently, the current treatment of negative goodwill is in difference to the previous approaches under IAS 22 (1983/1993/1998) fully aligned to the reason of bargain purchases.

Table 1. Extracts from Comment Letters on Accounting for Negative Goodwill

Bayer AG (Germany):
We believe it is essential to disclose the relevant management estimation of the 'source' of the negative goodwill. Recognizing negative goodwill directly through profit or loss is conceptually appropriate , but users need to be able to identify the future potential restructuring (or other) changes that led to such a 'bargain' purchase.
Rio Tinto plc (UK):
We would suggest that a better representation of the economics of the transaction would be pro-ratio against the identifiable net assets acquired [...]. This is particularly the case where the profit arises because of recognition or measurement exceptions for certain assets and liabilities e.g. post retirement liabilities measured on an IAS 19 basis may differ from those assumed in the purchase price.
Ministry of Finance / China Accounting Standards Committee (China):
[...] it is an unreasonable accounting mismatch to recognize all the negative goodwill in P&L and recognize loss in the following accounting periods, as it cannot reflect the economic substance appropriately. It is proposed hereby that the negative goodwill at the acquisition date should be treated as per its economic substance (that is, only the negative goodwill attributable to bargain purchases is recognized in P&L, and the other goodwill can be temporarily recorded in OCI or other liability accounts at the acquisition date).
Austrian Financial Reporting and Auditing Committee (Austria):
The recognition of negative goodwill [...] in profit or loss is conceptually unsatisfactory: goodwill is considered to be an asset, while negative goodwill is deemed to be a day one gain. [...] We also believe that negative goodwill often creates suspicion that artificial gains may have been recognized through the over-valuation of assets. We would therefore favour a cap on the recognition of intangible assets if their capitalization leads to an excess of the net identifiable assets over the fair value of the consideration.
Allianz (Germany):
In our opinion, positive and negative goodwill stem from the same reasons: In case of goodwill from additional future benefits which do not qualify as separate identifiable assets and in the case of negative goodwill from additional future costs for which no liability can be recognized as of the acquisition date. [...] we suggest to offset negative goodwill with the acquirer's equity instead of recognizing a one-off profit.

Ten years after the issuance of IFRS 3 (2004), however, the objection against the current treatment still seems to be existent. Thus, our analysis of the comment letters sent to the IASB during the recent PIR on IFRS 3 also revealed a considerable number of respondents that argue that negative goodwill may arise due to restructuring costs which cannot be recognized as provisions at the acquisition date or expected future operating losses of the acquiree. However, both may be considered during negotiations and accordingly factored into the purchase price¹⁵.

The potential reasons for negative goodwill transactions that have been discussed in the development of IFRS 3 are not exhaustive (Oppermann et al., 2014). With regard to the occurrence of a bargain purchase or "lucky buy", several additional reasons have been discussed, to date. For example, the management of the seller may view the business to be sold subjectively of minor importance or may not be willing to fund further investment projects to sustain a business due to alternative preferred opportunities (Oppermann et al., 2014). With regard to the possibility that errors in recognition or measurement are the source of a negative goodwill, this may be a result of the inevitable uncertainty and subjectivity which is

involved in valuation. Measurement errors resulting in negative goodwill may further result from the use of buyer-specific instead of market-based values or from differing views on valuation of the buyer and seller of a business.

In addition to the above, negative goodwill may also result from changes in market conditions. In general, it can be assumed that crisis situations such as the recent financial crisis increase the probability of negative goodwill transactions since the number of distressed sales is higher and more sales may occur in which the speed of the sale is the seller's priority. Furthermore, Wirth (2005) argues that negative goodwill may occur as a result of an extreme downturn of the stock market. Due to the decline of share prices it could be possible to acquire a firm for a price below the fair value of its net assets. In addition, negative goodwill may arise in situations in which (part of) the purchase price is paid in shares of the acquirer and the shares price decreases between the date at which the parties agreed on a fixed number of shares and the acquisition date. Other reasons for negative goodwill transactions include the measurement options for non-controlling interests, the recognition of acquisition-related costs as expenses or working capital guarantees.

Concluding, despite the assumption that in theory transactions which result in negative goodwill should rarely occur, a number of reasons was identified which may cause the recognition of an immediate gain. Figure 1 provides an overview of the reasons identified which forms the basis for our analysis of the disclosed reasons for negative

¹⁵ See, for example, the comment letters of EFRAG, Mazars, PricewaterhouseCoopers, CPA Australia Ltd., Confederation of Swedish Enterprise, Ministry of Finance [Peoples Republic of China]/China Accounting Standards Committee or Institute of Public Auditors in Germany (IDW) available at IASB (2014b). Extracts from the comment letters quoted are provided in Table 2 of the Appendix.

goodwill transactions in Germany in section 3.3 below.

3. EMPIRICAL EVIDENCE

3.1 Prior Research

As explained above, the IASB argues that transactions which result in negative goodwill should be rare in practice. However, only few academic studies exist that examine this assumption. While there are some publications that selectively interpret the applicable standards for negative goodwill accounting in Germany, i.e. IFRS 3; (e.g. Gros, 2005; Haaker, 2014) as well as in the US (e.g. De Merville and Petrie, 1989; Ketz, 2005; Comiskey and Mulford, 2008), there are only few studies that focus on an analysis of the relevance of negative good-will transactions in terms of their frequency or materiality.

With regard to US-GAAP, a comprehensive study was conducted by Comiskey et al. (2010) that document a total of 127 US firms with negative goodwill transactions in the time period from 2000-2007. However, business combinations during the sample period were subject to the Accounting Principles Board (APB) Opinion No. 16 for the years 2000-2001 and to the Statement of Financial Accounting Standard (SFAS) No. 141 afterwards. Both of these provisions required to proportionally reduce the fair values of a set of qualifying assets by the amount of initial negative goodwill. Any remaining amount of negative goodwill was either amortized to income over the subsequent periods under APB Opinion No. 16 or included as a day-one extraordinary gain under SFAS No. 141. Thus, similar to the provisions of IAS 22 explained in the previous chapter, the prevalence of negative goodwill was reduced by the design of the standard.

Nevertheless, in a detailed subsequent analysis for a subsample of 43 negative goodwill transactions, the authors find a high materiality of the phenomenon. On average (median), the ratio of negative goodwill to the acquirer's market capitalization amounted to 21 percent (seven percent). However, their event study did not show significant capital market reactions to the extraordinary gain resulting from negative goodwill.

Regarding the low frequency, Lys, Vincent and Yehuda (2012) also come to the conclusion that negative goodwill is unusual and infrequent under SFAS No. 141. Although they find that in a sample of 2,123 business combinations of US filers for the years 2002-2006, 230 acquisitions have a goodwill balance of zero that might result from a negative goodwill transaction, none of the examined companies explicitly disclosed such a situation.

With SFAS No. 141 (Revised 2007) becoming applicable for reporting periods starting on or after December 15, 2008¹⁶, the frequency as well as materiality of negative goodwill transactions was predicted to increase (Comiskey and Mulford, 2008). However, according to the annual Purchase Price Allocation Studies by Houlihan Lokey (2010; 2011;

2012; 2013; 2014) at least no significant increase in the number of negative goodwill transactions could be found for the US¹⁷.

With regard to the IFRS reporting regime, consecutive merger and acquisition studies for Europe's largest listed companies reveal with approximately three to eight percent of the total sample a relatively high frequency of negative goodwill transactions in the years 2005, 2007 and 2009 (Glaum et al., 2007; Glaum and Vogel, 2008; Glaum and Wyrwa, 2011)¹⁸. Thus, gains from bargain purchases appear to be indeed likely under IFRS 3. A study by the European Securities and Markets Authority (ESMA, 2014) strengthens the impression "that bargain purchases appear to happen more frequently than the IASB originally expected" (p. 3). In its analysis of the 2012 IFRS financial statements of 56 European listed companies with 66 business combinations during the reporting period, ESMA finds that negative goodwill was reported in 11 percent of all transactions.

Consequently, some first evidence exists that the IASB's assumption - negative goodwill transactions are rare in practice - might not be fully appropriate. As shown in this chapter, particularly studies examining business combinations under IFRS 3 indicate that "bargain purchases" are existent in today's financial reporting. We take these initial insights together with the scarce academic research in this field as a motivation to study the frequency and materiality of negative goodwill transactions for a broad cross-section of IFRS-reporting acquirers for the exemplary case of Germany.

3.2 Sample Selection and Data Description

Our initial sample consists of the firms listed in the main indices (DAX30, MDAX, TecDAX, SDAX) of the German stock exchange, Deutsche Börse AG¹⁹. Starting from fiscal year 2005, i.e. the first year for which all business combinations had to be accounted for under IFRS 3 (2004)²⁰, we consider the yearly index composition until fiscal year 2013²¹.

¹⁷ Houlihan Lokey find that negative goodwill transactions account for 0 to 1.8 percent of all transactions meeting the following search criteria for the years from 2009 to 2013, respectively: (1) the transactions are closed in the period of analysis, (2) the acquirer is a company traded publicly in the US, (3) the acquirer acquired more than 50 percent of the acquiree, and (4) explicit disclosures are provided for the business combination

¹⁸ For 2005, the authors find 14 individually disclosed negative goodwill transactions on a total sample of 266 disclosed transactions. For cases where only disclosures across all business combinations were available, two companies with aggregate negative goodwill were found on a total of 97 disclosures. For 2007, 10 of 377 in-dividually disclosed and 5 of 161 aggregately disclosed negative goodwill transactions are reported. For 2009, 17 of 212 individually disclosed and 3 of 82 aggregately disclosed negative goodwill transactions were found.

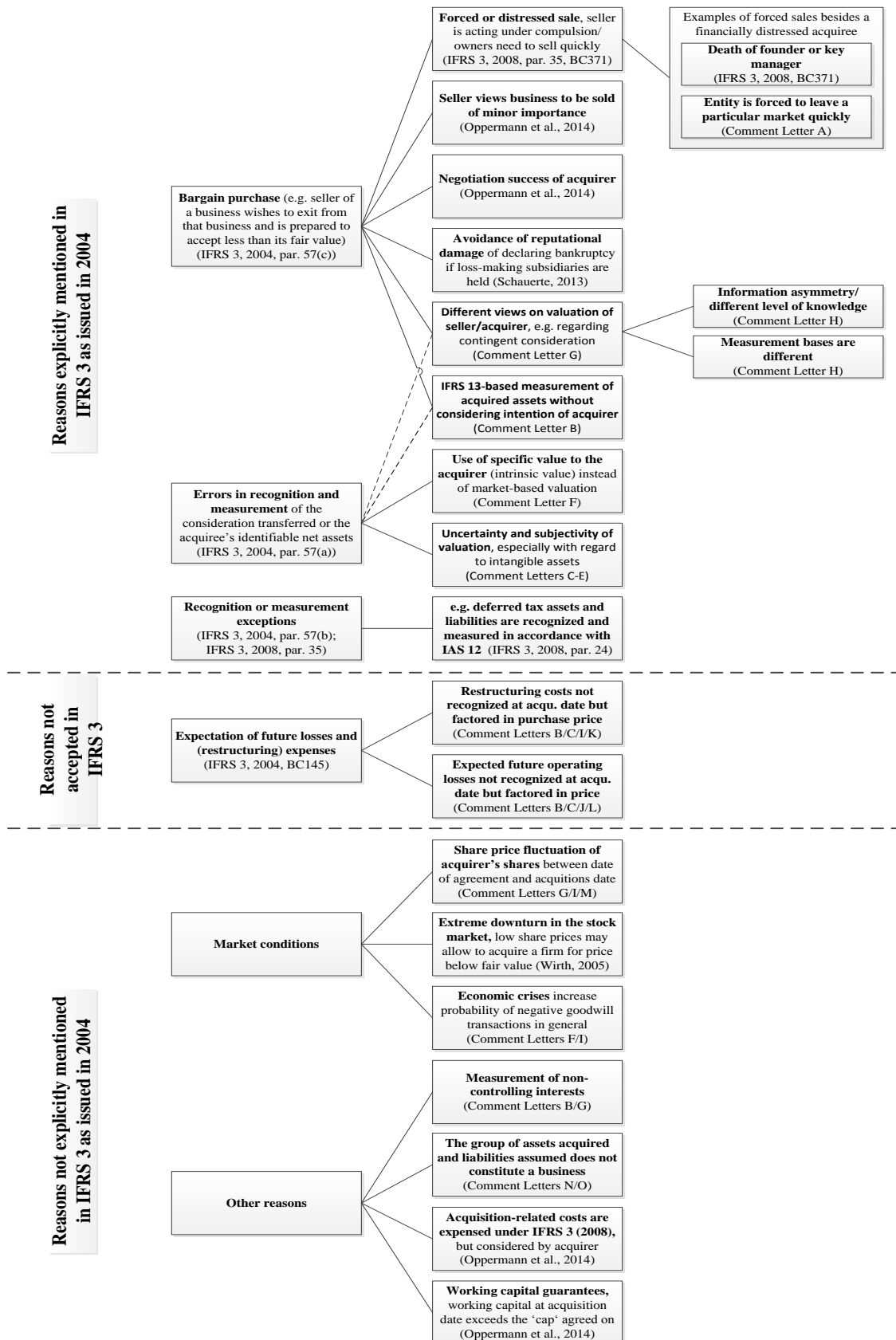
¹⁹ The DAX30, MDAX and SDAX are composed of the 130 largest companies by market capitalization of the prime standard segment. The TecDAX adds another 30 of the largest companies of the technology sector in the prime standard segment. For information on the individual indices refer to www.boerse-frankfurt.de (last retrieved on January 14, 2016).

²⁰ According to IFRS 3.78 (2004), the guidance of IFRS 3 (2004) shall be applied to business combinations occurring from March 31, 2004 onwards

²¹ Historical index compositions can be accessed on www.dax-indices.com (last retrieved on January 14, 2016).

¹⁶ SFAS No. 141 (Revised 2007) was developed in a joint project with the IASB and abolished the previously required pro rata reduction of allocation assets. Just like in IFRS 3 the full amount of negative goodwill be-came treated as a regular day-one profit.

Figure 1. Overview of Potential Reasons for Negative Goodwill under IFRS 3



Thus, our initial sample covers 1,440 firm-year observations. For this sample, we checked the item

"IQ_Impairment_GW" on S&P Capital IQ for positive values²² in order to identify potential bargain purchases. This initial sample of 74 firm-year observations was then made subject to a detailed analysis of the respective annual reports further reducing the sample to 61 firm-years which, in fact, contained business combinations resulting in negative goodwill²³. Furthermore, the review of the annual reports allowed for a refinement of the dataset breaking the firm-year observations down into individual transactions. As there are firms with more than one negative goodwill transaction per year, our final sample of 61 firm-year observations includes a total of 96 transactions.

Since the detailed disclosure requirements of IFRS 3 also apply to business combinations which result in negative goodwill, we were able to extract further relevant transaction data. Additional data that were hand collected for our subsequent analyses include whether the transaction has been accounted for under IFRS 3 (2004) or IFRS 3 (2008) as well as the target's profit and loss contribution since acquisition and for the full fiscal year. Moreover, the disclosures specifically relating to bargain purchases under IFRS 3.B64(n) (2008) and IFRS 3.67(h) (2004), respectively, i.e. the description of the reasons why the transaction resulted in a gain or the nature of such a gain, and the amount as well as line item under which the gain is recognized in the income statements are examined.

3.2 Relevance of Negative Goodwill

3.2.1 Frequency

Due to the requirement to disclose the amount of negative goodwill recognized per transaction and the respective description of the acquiree, we were able to attribute the aggregate firm-year negative goodwill amounts retrieved from S&P Capital IQ to a total of 96 individual transactions.²⁴ These correspond to a set of 61 firm-year observations and 39 individual companies with at least one negative goodwill transaction. Compared to the total sample of 1,440 firm-year observations, 4.2 percent of the DAX30, MDAX, TecDAX and SDAX constituents report a gain from negative goodwill between 2005 and 2013. Furthermore, companies that recorded a negative goodwill during the sample period have on average not just one - as the IASB's description of the anomalous nature of negative goodwill

transactions would suggest - but 2.5 negative goodwill transactions.

In a more detailed analysis, we discovered that the company most regularly disclosing negative goodwill transactions is Arques Industries AG. Before changing its name and business model in 2010²⁵, the company focused its strategy on the acquisition of non-core business affiliates of international corporations²⁶ and of restructuring targets. With this strategy, Arques Industries AG acquired a total of 24 targets with negative goodwill in the years from 2006-2008. While an examination of the disclosed reasons is conducted in section 3.3, the described business model combined with the high sample contribution of 25 percent of all observed negative goodwill transactions indicates that negative goodwill might especially arise from the acquisition of targets in financial distress.

The example of Arques Industries AG, an investment company specialized on the acquisition of restructuring targets, suggests an analysis of the distribution of negative goodwill transactions per industry sector. Table 3 shows the 96 negative goodwill transactions by industry and illustrates the share each sector contributes to the negative goodwill sample. Arques Industries AG is thereby shown as a separate line due to its exceptionally high contribution and its reclassification from an investment to an equipment company in 2010.

As shown in Table 3, the manufacturing sector contributes the greatest share to the sample of negative goodwill transactions with 29 percent followed by the finance, insurance and real estate sector with 20 percent. This industry distribution is consistent with Comiskey et al. (2010) who find that the manufacturing sector accounts for 56 percent and the financial sector for 19 percent of their sample of US-listed firms reporting negative goodwill transactions between 2000 and 2007²⁷.

A first interpretation of the high frequency of negative goodwill transactions in the manufacturing as well as other capital intensive industries such as the construction, mining and transportation sectors which together contribute 44 percent to our sample suggests that the often mentioned reason of an incorrect (and subjective) valuation of intangible assets might not be the main trigger for the occurrence of negative goodwill transactions. However, the great quantity of negative goodwill transactions in the manufacturing sector has to be modified in light of the high number of firm-year observations from that industry sector in our overall sample. In comparison to all firm-year observations from the manufacturing sample, negative goodwill

²² This item contains the net amount of goodwill impairment charges and income from bargain purchase transactions. Considering the rather low frequency of these two items, we examine all firm-years exhibiting a positive amount for "IQ_Impairment_GW", acknowledging that this procedure may understate the prevalence of bargain transactions. We thank Tobias Stork genannt Wersborg for the provision of this data.

²³ Observations which have been excluded from our sample include, for example, negative goodwills resulting from the acquisition of interests in joint ventures or from time differences between the transfer of control and full consolidation. An example of the latter situation poses the Deutsche Euroshop AG disclosing a negative goodwill of 0.692 million euro in its 2009 annual report resulting from the first-time consolidation of a previously controlled subsidiary

²⁴ For four firm-year observations, the amounts of negative goodwill were only disclosed in aggregate form. We split the sums evenly across the ten respective transactions that were described to have a negative goodwill. In this way, the frequency of negative goodwill transactions should not be distorted by the disclosure choices of the underlying sample firms

²⁵ In 2010, the company changed its name to Gigaset AG and shifted its strategy to becoming a producer and distributor of telecommunication equipment.

²⁶ From his practical experience, Schauerte (2013) explains that large corporations often accept acquisition prices below the fair value for loss-generating affiliates as to avoid the damage to their corporate image by declaring bankruptcy.

²⁷ The industry distribution found by Comiskey et al. (2010) is especially noteworthy as during the time of analysis the ABP Opinion No. 16 or later the SFAS No. 141 required the allocation of negative goodwill against qualifying acquired assets so that only transactions with excess amounts of negative goodwill became part of their sample. The authors further explain that qualifying assets such as property, plant and equipment are mostly found in capital intensive industries such as in manufacturing, energy or metal firms. Therefore, an even greater sample contribution could be expected for the manufacturing sector under full gain recognition of negative goodwill

transactions can only be observed in 4 percent of the cases. Consequently, the distribution of negative goodwill transactions might simply stem from the index composition and the greater subsample of firm-year observations in the manufacturing sector.

Regarding the financial industry, the observations for the real estate sector stand out. The subsector does not only contribute 18 percent to our sample of negative goodwill transactions but also shows the highest percentage of firm-year observations with negative goodwill transactions (23 percent). This indicates that sector-specific factors may contribute to the probability of negative goodwill transactions. In the analysis of the reasons

in section 3.3, we will therefore place emphasis on the nature of negative goodwill in the real estate sector. While the industry analysis showed a high frequency of negative goodwill transactions in the real estate sector, our observations appear fairly equally distributed across the sample period between 2005 and 2013 (see Table 4).

This is especially the case when excluding the observations relating to Arques Industries AG. Furthermore, the revision of IFRS 3 with the changes outlined in section 2.1 does not seem to have remarkably affected the frequency of negative goodwill transactions.

Table 3. Frequency of Negative Goodwill Transactions by Industry

<i>Industry (by SIC Codes)</i>	<i>Number of NGW Transactions</i>	<i>Percent of NGW Sample</i>	<i>Number of Firm-Years</i>	<i>Percent of Firm-Years</i>
Agriculture, Forestry, Fishing (01-09)	3	3.13%	17	17.65%
Mining (10-14)	6	6.25%	26	23.08%
Construction (15-17)	1	1.04%	32	3.13%
Manufacturing (20-39)	28	29.17%	683	4.10%
Apparel (23)	(1)	(1.04%)	(31)	(3.23%)
Chemicals (28)	(2)	(2.08%)	(130)	(1.54%)
Rubber and Plastic (30)	(4)	(4.17%)	(35)	(11.43%)
Stone, Clay, Glass and Concrete Products (32)	(1)	(1.04%)	(24)	(4.17%)
Primary Metals (33)	(3)	(3.13%)	(20)	(15.00%)
Equipment (35-37)	(17)	(17.71%)	(374)	(4.55%)
Transportation & Public Utilities (40-49)	7	7.29%	148	4.73%
Wholesale Trade (50-51)	4	4.17%	59	6.78%
Retail Trade (52-59)	2	2.08%	55	3.64%
Finance, Insurance, Real Estate (60-67)	19	19.79%	209	9.09%
Depository Institutions (60)	(1)	(1.04%)	(49)	(2.04%)
Insurance Carriers (63)	(1)	(1.04%)	(32)	(3.13%)
Real Estate (65)	(17)	(17.71%)	(73)	(23.29%)
Services (70-89)	2	2.08%	188	1.06%
Arques Industries	24	25.00%	-	-
Total	96	100.00%	1417	6.77%

Notes: The table above illustrates the frequency distribution of negative goodwill (NGW) transactions per industry sector. The sectors are assigned with help of the two-digit Standard Industrial Classification (SIC) codes for the acquirer's primary business activity as retrieved from Thomson Reuters DataStream and S&P Capital IQ. For 23 firm-years the SIC codes could not be assigned reducing the sample to 1,417 observations. For the industries with the highest contribution to the sample of negative goodwill transactions, the frequencies of the subsectors are listed in brackets.

Excluding Arques Industries AG, 40 percent of our observations fall under IFRS 3 (2008) that had to be applied to business combinations during fiscal years starting on or after July 1, 2009. However, as none of our firms with negative goodwill transactions start their fiscal year in the mid of 2009, IFRS 3 (2008) was applicable to business combinations in four out of the nine years of our sample period. Moreover, the analysis of negative goodwill transactions does not provide strong support for the assumption that the probability of negative goodwill transactions is higher in crisis periods. Excluding Arques Industries AG, the number of negative goodwill transactions during the years of the recent financial crisis (in particular, 2008 and 2009) does not differ substantially from earlier and subsequent periods.

Summarizing the frequency analysis, our results provide support for the conclusions of ESMA (2014) and statements of several respondents during the PIR on IFRS 3 (see again section 1) that the phenomenon of negative goodwill transactions is not as rare as the standard would suggest. Furthermore, this section identified the exceptional case of Arques Industries AG and the high frequency of negative goodwill transactions in the real estate sector. While this section purely focused on the frequency of the phenomenon, the following analyses will investigate whether the observed negative goodwill transactions are also relevant in terms of their materiality, especially with regard to the income statement of the acquirer.

Table 4. Frequency of Negative Goodwill Transactions by Year and Standard

<i>Year</i>	<i>Number of NGW Transactions</i>	<i>(Thereof Arques Industries)</i>	<i>Percent of Sample</i>
2005	6	(0)	6,25%
2006	16	(11)	16,67%
2007	23	(9)	23,96%
2008	13	(4)	13,54%
2009	9	(0)	9,38%
2010	6	(0)	6,25%
2011	12	(0)	12,50%
2012	8	(0)	8,33%
2013	3	(0)	3,13%
Total	96	(24)	100,00%

<i>Standard</i>	<i>Number of NGW Transactions</i>	<i>(Thereof Arques Industries)</i>	<i>Percent of Sample</i>
IFRS 3 (2004)	67	(24)	69,79%
IFRS 3 (2008)	29	(0)	30,21%
Total	96	(24)	100,00%

Notes: The table above illustrates the annual frequency distribution of negative goodwill (NGW) transactions for the years 2005-2013 and for the applicable versions of IFRS 3 (2004/2008). Due to the high frequency of negative goodwill transactions observed for Arques Industries AG (or later: Gigaset AG), the third column separately depicts the yearly number of negative goodwill transactions attributable to the respective acquirer. The "percent of the sample", however, includes all negative goodwill transactions of the sample.

3.2.2 Materiality

Since the introduction of IFRS 3 in 2004, negative goodwill is fully recognized as a day-one profit. While some studies as well as anecdotal evidence indicate that the frequency of negative goodwill has been underestimated by the IASB, to the best of our knowledge, no comprehensive study exists which examines whether the resulting gains are material to the income statement of the acquirers. The only exception is the study by ESMA (2014) which documents the materiality for seven negative goodwill transactions arising in the year 2012 and finds that on average gains from negative goodwill make up for 12 percent of net income before taxes.

A further gap in understanding could be identified with the review of the comment letters that revealed the ambiguity under what line item gains from negative goodwill transactions should be recognized. IFRS 3 (2004/2008) does not prescribe a specific line item, an approach that is criticized by standard users as it is said to impede the comparability of income statements (IASB, 2014b)²⁸. Our analysis of the disclosure required by IFRS 3.64(n)(i) (2008), however, shows that even without the specification, the recognition of negative goodwill is handled consistently across our sample. In particular, we find that 94 out of the 96 negative goodwill transactions directly contribute to the operating result (EBIT) of the acquirer and are usually recorded under a line item called "Other operating income". Thus, negative goodwill is not highlighted in the income statement as an income flow of extraordinary character but directly increases the operating result of the acquirer.

This recognition technique is particularly noteworthy as the IASB highlights in IFRS 3.BC378 (2008) that "[financial analysts and other users have often told the boards that they give little weight to one-off or unusual gains, such as those resulting from a bargain purchase transaction]". The

recognition under operating income, however, makes it more difficult for analysts to identify negative goodwill as such an unusual transaction. In particular, the inclusion in a line item such as "Other operating income" - thus, reporting the gain commingled with other income sources - requires more effort to identify what analysts aim to disregard. Or are such gains typically of so little weight that an in-depth analysis is not even considered necessary or useful?

Table 5, however, does not support the latter thought and shows instead that negative goodwill transactions can be of considerable materiality to the financial statements of acquiring firms. The negative goodwill transactions of our sample result in an average (median) gain of 20.9 million euro (3.9 million euro). Also in relative terms, negative goodwill substantially contributes to the acquirer's income in the period of acquisition. Thus, the gain from a negative goodwill transaction as a fraction of the acquirer's operating income results in an average (median) of 16 percent (4 percent) for the sample period between 2005 and 2013. In a next step, we follow ESMA (2014) and calculate also the ratio of gains from negative goodwill transactions over net income before taxes. For our full sample period, we obtain an average of 48 percent which is a remarkable fraction in comparison to the 12 percent in the study by ESMA for the year 2012.

Relative to the size of the acquirer, Table 5 shows that even when opposed to the respective acquirer's market capitalization, which is drawn from a sample of Germany's largest listed companies, gains from negative goodwill transactions account on average (median) for 4 percent (1 percent).

²⁸ See the comment letter of the Financial Reporting Council of Mauritius stating: "IFRS 3 does not specify where in the profit or loss the excess should be shown. This impedes comparability and the Standard should require presentation of this gain on the face of the profit or loss" (IASB, 2014b).

Thereby, it is to highlight that we chose a rather conservative approach in assessing the materiality of gains from negative goodwill transactions. As the frequency analysis revealed, we observed for several firm-year observations more than one negative goodwill transaction. In-stead of clustering the resulting gains on a yearly basis, we analyzed the materiality for each separate transaction. Furthermore, we opposed the transaction gains to the operating result and the net income before taxes as reported instead of deducting the gains from negative goodwill

transactions. To still judge upon the materiality of the phenomenon for negative income results, we used the absolute ratios in such cases.

As the difference in the averages and medians of Table 5 suggests, there are a number of cases with exceptionally high negative goodwill in our sample. Table 6 shows examples of these transactions and their characteristics with the intent of demonstrating the extraordinary role gains from negative goodwill transactions can overtake in selected cases.

Table 5. Materiality of Negative Goodwill Transactions

Variable	Number of NGW Transactions	Average	Standard Deviation	10th Percentile	Median	90th Percentile
NGW in MEur	96	20.85	50.43	0.33	3.94	57.67
NGW over EBIT	96	0.16	0.48	0.00	0.04	0.37
NGW over net income before taxes	96	0.48	2.70	0.00	0.04	0.48
NGW over market capitalization	96	0.04	0.14	0.00	0.01	0.07

Notes: The table above illustrates the average, median and percentile ranges for all 96 negative goodwill (NGW) transactions of our sample in absolute as well as relative terms to income and firm size figures. The firm-year specific data for the respective acquirers (e.g. market capitalization) was retrieved from Thomson Reuters DataStream. As for the income ratios, the gains from negative goodwill transactions were not subtracted from the operating or net income results. In cases of negative income figures, the absolute ratios were used for calculations.

Table 6. Selected Transactions with High Materiality of Negative Goodwill

Name of Acquirer	Name of Acquiree	Fiscal Year	NGW in MEur	NGW over EBIT	NGW over Net Income before Taxes	NGW over Market Capitalization
Metro Group	Wal-Mart Germany Group	2006	410.00	0.20	0.27	0.03
Singulus Technologies AG	STEAG HamaTech AG	2006	33.78	4.33	7.92	0.08
Arques Industries AG	Siemens Home and Office Communication Devices	2008	81.70	0.80	0.55	1.29
Deutsche Lufthansa AG	Austrian Airline AG	2009	87.00	1.34	0.38	0.02
Deutsche Bank AG	ABN Amro Bank N.V.	2010	216.00	0.03	0.04	0.01
Tom Tailor Holding AG	Bonita Group	2012	11.10	0.67	25.46	0.03

Note: The table above illustrates the transactions of our sample with the highest absolute or relative negative goodwill. The grey fields are to highlight the extraordinary character of the selected transactions

After having shown the high materiality of gains from negative goodwill transactions for our sample, the question arises whether the in section 3.2.1 identified high frequencies in the manufacturing and real estate sector are also of substantial materiality. While with 19 percent the manufacturing sector indeed shows an above average negative goodwill over EBIT ratio compared to the full sample of negative goodwill transactions, the median only amounts to 2 percent (see Table 7). These results indicate that materiality in the manufacturing sector is driven by extraordinary transactions such as the acquisition of STEAG HamaTech by Singulus Technologies illustrated in Table 6. When excluding the latter transaction the average ratio decreases to 4 percent for the manufacturing sector.

However, the real estate sector shows a high materiality in terms of the average gain from

negative goodwill over EBIT with 13 percent and the median with 8 percent. Further industry patterns are difficult to detect as there are either only few negative goodwill transactions in the respective sector (e.g. in the retail trade industry) or the results are driven by extraordinary transactions (e.g. the acquisition by Deutsche Lufthansa in the transportation and public utilities industry).

While in the previous section it was shown that negative goodwill transactions are not as rare as might be expected, the analyses in this section identified the substantial impact gains from negative goodwill transactions can overtake for the financial performance of the acquirer. In the following, we will focus on the acquirer's disclosures which are supposed to enable users of financial statements to understand why the transaction resulted in negative goodwill.

Table 7. Negative Goodwill over EBIT per Transaction and Industry

<i>Industry (by SIC Codes)</i>	<i>Number of NGW Transactions</i>	<i>Average</i>	<i>Standard Deviation</i>	<i>10th Percentile</i>	<i>Median</i>	<i>90th Percentile</i>
Agriculture, Forestry, Fishing (01-09)	3	0.04	0.04	0.01	0.05	0.07
Mining (10-14)	6	0.05	0.07	0.00	0.02	0.13
Construction (15-17)	1	0.61	-	-	-	-
Manufacturing (20-39)	28	0.19	0.81	0.00	0.02	0.11
Transportation & Public Utilities (40-49)	7	0.20	0.50	0.00	0.02	0.56
Wholesale Trade (50-51)	4	0.00	0.00	0.00	0.00	0.00
Retail Trade (52-59)	2	0.44	0.33	0.25	0.44	0.62
Finance, Insurance, Real Estate (60-67)	19	0.12	0.13	0.01	0.07	0.33
Depository Institutions (60)	(1)	(0.03)	(-)	(-)	(-)	(-)
Insurance Carriers (63)	(1)	(0.07)	(-)	(-)	(-)	(-)
Real Estate (65)	(17)	(0.13)	(0.14)	(0.01)	(0.08)	(0.34)
Services (70-89)	2	0.02	0.01	0.02	0.02	0.03
Arques Industries	24	0.19	0.24	0.00	0.12	0.48
Total	96	0.16	0.48	0.00	0.04	0.37

Notes: The table above illustrates the average, median and percentile ranges for all 96 negative goodwill (NGW) transactions of our sample and their ratio of negative goodwill over earnings before interests and taxes (EBIT). The results are grouped by their industry sector that is identified with help of the two-digit Standard Industrial Classification (SIC) codes for the acquirer's primary business. Due to the high frequency of negative goodwill transactions and its industry reclassification in 2010, Arques Industries AG (or later: Gigaset AG) is depicted in a separate line. Furthermore, the finance, insurance and real estate industry is subdivided into its subsectors with the respective results being indicated in brackets.

3.3 Reasons for Negative Goodwill

The importance of adequate information to enable financial statement users to understand and evaluate a transaction that led to negative goodwill has often been emphasized. For example, the ESMA (2014) and several respondents during the recent PIR on IFRS 3 highlight the importance of disclosures about the reasons for a "bargain purchase"²⁹. The IASB addressed this need in the initial version of IFRS 3 issued in 2004 with the requirement to describe the nature of the gain (IFRS 3.67(h) (2004)). In the revised standard, the IASB introduced the more specific requirement to describe "the reasons why the transaction resulted in a gain" (IFRS 3.B64(n)(ii) (2008)).

To examine the reasons for the occurrence of a negative goodwill, we analyzed the notes to the financial statements of all firm-year observations that exhibited a negative goodwill transaction. Table 8 provides an overview of the disclosure practice and compliance with the requirements. For 61 (64 percent) of all negative goodwill transactions the firms did neither provide a description of the nature of the gain nor a description of the reasons why the transaction resulted in negative goodwill. In ten cases (ten percent) firms only provided boilerplate or meaningless disclosures which do not go beyond an explanation on the mathematical mechanics of business combinations accounting. The remaining 25 (26 percent) of the negative goodwill transactions are accompanied by a description which explains why a gain was recognized.

Moreover, our analysis indicates that the change introduced by IFRS 3 (2008) to require information about the reasons, why negative goodwill occurred, improved the quality of firms' disclosures about negative goodwill transactions. While almost 80 percent of the transactions accounted for under IFRS 3 (2004) were not

accompanied by any description of the gain recognized by the acquirer, meaningful reasons for negative goodwill have been described by the majority of firms (62 percent) under the current version of the standard. However, the number of meaningless or missing disclosures is still remarkable.

In a next step, we clustered all disclosures describing the nature or reasons for negative goodwill transactions according to our framework of potential reasons developed in Figure 1. Table 9 summarizes our results and shows that, in line with the reasoning of the IASB, "bargain purchases" account for the most frequently disclosed reasons of negative goodwill. As expected, we do not find any reasons relating to errors regarding recognition or measurement of identifiable net assets acquired or of the consideration transferred. If the firms and its auditor are aware of errors resulting in a negative goodwill transaction during the reporting period, this should already have been corrected prior to the issuance of the annual report, of course. Moreover, the requirement for reassessment in case of the existence of a negative goodwill according to IFRS 3.36 (2008) may help to mitigate the likelihood of errors. It is noteworthy, however, that the third possible reason mentioned by the IASB in 2004, exceptions from the recognition and measurement principles that are generally applicable to business combinations, does also not result in a negative goodwill transaction in our sample. Based on these findings, the current treatment of recognizing negative goodwill immediately as a gain seems appropriate, if one accepts that only these three reasons as mentioned by the IASB in 2004 may cause a negative goodwill result.

Nevertheless, some descriptions for the origin of negative goodwill leave room for interpretation relating especially to the measurement sub-categories of "bargain purchases". The level of detail does not always allow for a clear-cut distinction of whether (1) the "highest and best use" principle is applied according to IFRS 13 but the net assets are worth less to the specific acquirer or of whether (2) the lower purchasing price results from different

²⁹ See, for example, the comment letters of the Association of Chartered Certified Accountants, American Appraisal (UK) Ltd. Bayer AG, CPC, the Norwegian Accounting Standards Board or TÜV SÜD AG available at IASB (2014b).

views on valuation by the involved parties. Especially in the latter case, we find that more elaborate descriptions would be desirable since great differences in valuation should be limited by the assumption that sellers – excluding companies pressured by the threat of financial distress or even

insolvency – should not be willing to close a deal for a price below the business' value. Consequently, disclosures describing measurement differences in little detail might call into question the validity of gains resulting from negative goodwill (see again Comment Letter E of Table 2 in the Appendix).

Table 8. Disclosure of Reasons for Negative Goodwill Transactions

Disclosed Reasons	Number of Observations	Percent of NGW Transactions	Number of Observations IFRS 3 (2004)	Percent of Observations IFRS 3 (2004)	Number of Observations IFRS 3 (2008)	Percent of Observations IFRS 3 (2008)
Disclosed Reason	25	26.04%	7	10.45%	18	62.07%
Boilerplate	10	10.42%	8	11.94%	2	6.90%
No Disclosed Reason	61	63.54%	52	77.61%	9	31.03%
Total	96	100.00%	67	100.00%	29	100.00%

Notes: The table above illustrates for all 96 transactions of our sample whether the reasons for the recognition of negative goodwill are disclosed. For transactions where the reasons are disclosed we further distinguish if the provided information is reasonable as to explain the occurrence of negative goodwill (otherwise classified as boilerplate). Additionally, column 4 and 6 split the observations by the applicable versions of IFRS 3 (2004/2008).

Table 9. Classification of Disclosed Reasons

Disclosed Reasons	Number of Observations	Percent of Disclosed Reasons	Number of Observations Real Estate	Number of Observations Manufacturing
Bargain purchase	13	36.11%	7	2
Errors in recognition and measurement	0	0.00%	0	0
Recognition or measurement exceptions	0	0.00%	0	0
Expectations of future losses and restructuring expenses	7	19.44%	0	2
Market conditions	6	16.67%	3	2
Other	0	0.00%	0	0
Boilerplate	10	27.78%	2	6
Total	36	100.00%	12	12

Notes: The table above shows the disclosed reasons according to the framework of potential reasons developed in Figure 1. Thereby, more than one reason can be indicated so that the 36 classifications concern 35 negative goodwill transactions with the respective disclosures. The dotted lines are to separate the reasons that are explicitly mentioned by IFRS 3 (2004) (i.e. bargain purchase, errors, exceptions), the reasons explicitly not accepted (i.e. expectations of future losses and restructuring expenses) and the reasons not explicitly mentioned (i.e. market conditions and others). Column 4 and 5 further indicate what reasons could be found in the real estate and manufacturing sectors, in particular.

Apart from the reasons explicitly accepted by the IASB, Table 9 shows that reasons, which were not accepted (i.e. expectations of future losses and restructuring expenses) or not mentioned (i.e. market conditions and other) by the IASB, also lead to a remarkable number of negative goodwill transactions. Together, they are of equal importance as to explain the existence of negative goodwill for our sample.

Having identified that the expectation of future losses and expenses (especially related to restructuring) is one of the major stated reasons for a negative goodwill, as argued by opponents to the current treatment, we are interested in the acquirer's performance after the acquisition. To examine whether acquirers incur, in fact, losses after the negative goodwill transaction, we examine the specific disclosures required by IFRS 3.64(q) (2008) regarding the profit or loss which was contributed to the consolidated income statement of the group from the acquisition date to the end of the reporting period. Our analysis reveals that out of the 59 disclosed profit and loss contributions the acquirer contributed in 29 transactions (49 percent) nothing or even a negative result to the consolidated income of the group after the acquisition. These results suggest that the "Expectations of future losses and restructuring expenses" as a reason for a negative

goodwill might even be understated by the number of firms which explicitly disclosed this explanation³⁰.

Another six (17 percent) observations relate to the reason "Market conditions" which was not mentioned by the IASB. Thereby, the descriptions of our sample cover two scenarios, with the first one arising from the consideration being paid (at least partially) in the form of a fixed amount of shares whose price changed between the closing of negotiations and their ultimate handover. The second case is also connected to the acquisition via a share deal, in which the acquirer overtakes at least the proportion of shares (and voting rights) that will secure control over the acquiree. However, when the price for the shares of the acquiree is lower than the fair value of the net assets acquired, a negative goodwill results.

While fluctuations in share prices stemming from time differences in the transfer of shares should be avoidable via contractual design, the second scenario is especially noteworthy as market participants – via their estimations of the share price – view the future prospects of the acquiree

³⁰ The comment letter by the Accounting Standards Board of Japan (ASBJ) supports the observations from our sample as follows: "Some preparers stated that after they recognised gains on negative goodwill for business combinations, they often ended up recognising losses in subsequent periods" (IASB, 2014b).

negatively thus contributing to the occurrence of a negative goodwill. Consequently, the nature and interpretation of such transactions appears related to the category of "Expectations of future losses and restructuring expenses".

Taking the above into consideration, our results indicate that the quality of disclosures has been improved over time and more and more firms are describing the reasons for negative goodwill transactions. With regard to classifying the content of these disclosures, we find interesting results. While the real "bargain purchase" or "lucky buy" appears to be the dominant reason, especially when focusing on the reasons mentioned explicitly by the IASB when IFRS 3 (2004) was introduced, the expectation of future losses and (restructuring) expenses seems to be a noteworthy reason for the phenomenon under consideration. Moreover, market conditions, especially the development of share prices, overtake a central role for the occurrence of negative goodwill, a reason that has been understated by the IASB in the past. Given the relatively high frequency of explanations other than real "bargain purchases", it appears questionable whether the immediate recognition of the full gain from negative goodwill is the most appropriate accounting treatment of the phenomenon and it should thus be reconsidered whether a more differentiated treatment according to the underlying reasons of negative goodwill would be a better alternative.

4. CONCLUSION AND AVENUES FOR FUTURE RESEARCH

Why would a seller willingly sell a business below its value to an unrelated party? During the development of IFRS 3 (2004), the IASB considered transactions, in which the fair value of the acquired assets and liabilities assumed exceeds the cost of a business combination, as anomalous and rarely occurring. Ten years later, the questions of how often business combinations result in negative goodwill, how material the amounts are to the financial statements of the acquiring firms, and, importantly, why such transactions occur are still not answered convincingly.

This paper documents the relevance of negative goodwill transactions to German IFRS practice. For a sample of the yearly 160 largest German listed firms for the years 2005 to 2013, we find 96 negative goodwill transactions indicating that the phenomenon is not as rare as might be expected. Moreover, our analyses show that the gains recognized are contributing to the acquirers' operating results, i.e. EBIT, and that amounts are generally material. In particular, gains from "bargain purchases" account on average for 16 percent of the acquirers' EBIT.

With regard to the reasons for negative goodwill transactions, the quality of the disclosures provided improves over time, probably at least to some extent attributable to the change in the requirements from IFRS 3 (2004) to IFRS 3 (2008). Overall, however, the notes to financial statements often lack information to understand the nature or reason of the gain recognized as a result of the business combination. Our analysis shows that the reason stated most often by acquirers is that the

firm closed a "bargain purchase", while no firm disclosed errors or exceptions from the general recognition or measurement principles of IFRS 3 as a cause for negative goodwill. Although this seems to support the current treatment of negative goodwill under IFRS, a noteworthy number of firms disclosed reasons related to the expectation of future losses or restructuring expenses and market conditions, such as low share prices of the acquiree. This calls into question whether the current treatment of negative goodwill as a day-one (operating) gain is always the most appropriate.

With the above findings, our study contributes to the academic literature on business combinations accounting. To date, few descriptive studies exist that focus on negative goodwill transactions. Our results should, however, be of interest beyond academic research. In particular, we call upon enforcement institutions to become aware of the room for improvement with regard to the disclosures of reasons for negative goodwill, that are emphasized to be important for users as to understand the conditions of the gain and that constituted the main focus areas of enforcers in recent years. Moreover, standard setters, especially the IASB, should be interested in empirical evidence on the frequency, materiality as well as the reasons for negative goodwill transactions, a phenomenon which is not as rare (and immaterial) as expected a decade ago.

Our study is, however, subject to certain limitations. First, we are focusing on a single country, Germany. However, this design allows us to examine a greater width of firms instead of some few pre-selected firms from multiple countries and to avoid country-specific bias. Moreover, our results are drawn from a sample of only 96 identifiable transactions that is to the authors' best knowledge nevertheless the greatest sample of negative goodwill transactions ever studied. A further important caveat is the examination of reasons as stated by the preparers of IFRS financial statements. Of course, this may not in every case reveal the underlying reasons, especially in the case of missing disclosures. Thus, future research should explore the determinants of negative goodwill transactions beyond what the acquirers explicitly disclose. These results could then be compared to the findings presented in this study. A further fruitful research opportunity lies in studying the consequences of negative goodwill transactions: Do investors really care about the non-recurring gain from negative goodwill transactions?

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Appendix

Table 2. Extracts from Comment Letters on Reasons for Negative Goodwill

Comment Letter A - Association of Chartered Certified Accountants (ACCA, UK):

Negative goodwill can arise for very specific economic reasons, such as when an entity is **forced to leave a particular market quickly**, or makes the decision to do so on the grounds of a perceived longer-term benefit.

Comment Letter B - Mazars (France):

[A] negative goodwill is frequently justified by **future restructuring expenses, or future operating losses** to be incurred before restoring the profitability of the acquiree, that the acquirer cannot account for at acquisition date. [...] Sometimes, negative goodwill could also arise from **IFRS 13** measurement of acquired assets, according to the **'highest and best use' principle**, without having considered the acquirer's objectives. [...] Negative goodwill is even more counter-intuitive when it is increased by choosing to measure **NCIs at fair value** (i.e. when the fair value of NCIs is lower than their share in the fair value of the net assets of the acquiree).

Comment Letter C - European Financial Reporting Advisory Group (EFRAG):

Some respondents believe that the recognition of negative goodwill could indicate the presence of structural problems in the acquiree that could result in a **future liability for restructuring costs**. [...] In cases where negative goodwill results mainly from **anticipated future losses**, the immediate recognition of negative goodwill as a gain in profit or loss leads to a periodic mismatch when the future losses are recognized [...]. Another respondent noted that a 'gain' generated by the **fair valuation of items such as intangible assets** [...] should not be recognized on the date of the acquisition. There is a risk that the company could recognize a 'bargain purchase' at the acquisition-date based on **judgmental values** and in future years recognize an impairment loss if the 'fair value' estimated was not correct.

Comment Letter D - Austrian Financial Reporting and Auditing Committee (AFRAC, Austria):

We also believe that negative goodwill often creates suspicion that **artificial gains** may have been recognized through the **over-valuation of assets**. [...] In our opinion, the fair value of intangibles alone should not lead to a gain from a bargain purchase.

Comment Letter E - Roche (Switzerland):

We do not believe a 'gain' generated by the **fair valuation of items such as intangible assets** [...] should be recognized on day one. Given the existing IFRS 3 requirements, there is a risk that a company could recognize a 'bargain purchase' gain at acquisition based on judgmental fair values from what they believe is a bargain from, for example, a 'distressed seller' and then years later book an impairment charge upon crystallization if the 'fair value' they assumed was incorrect and could not be realized.

Comment Letter F - American Appraisal Ltd (US):

We find it improbable that any acquirer can make a series of purchases that result in negative goodwill if the 'market participant' assumptions of fair value are applied correctly. If an acquirer is constantly recognizing gains from negative goodwill, we consider that this most likely is a result of using an **'intrinsic value' basis**, which considers specific value to that buyer, rather than using the fair value basis and its market-participant-based assumptions. [...] Negative goodwill is more common in **crisis situations** (more distressed sales, more sales where the vendor's primary concern is speed of sale) and there are questions over whether the rules account for this.

Comment Letter G - Grant Thornton International Ltd (UK):

Bargain purchase gains also arise for reasons that seem less or unrelated to the economics of the negotiated exchange, for example: - **differences of view on valuation** including, but not limited to, the acquisition date fair value of contingent consideration and intangible assets [...] - short-term **fluctuations/market reactions in the quoted price** of the acquirer's shares when part of the consideration is transferred - combinations in which the fair value of NCI is lower than the NCI's share of net identifiable assets and NCI is recorded at fair value. In this context we note IFRS 3.34 requires this gain to be attributed to the acquirer.

Comment Letter H - Comit  de Pronunciamentos Cont beis (CPC, Brazil):

[...] it is clear to assume, when a business is offered for sale, that the seller will estimate the price for which the business could be sold, and this involves measuring the value of that business both as a continuing operation [...] and as a discontinued operation [...], and certainly the seller will target to sell it for the higher of the two resulting figures. Therefore, in practice, if the fair value of net assets is the higher amount, this will be the price asked by the seller regardless of what the acquirer will do with the business (whether continue or discontinue the operations) and its net assets (use or sell them). Accordingly, apart from a possible gain from a bargain purchase arising from poor measurements, given the existing exceptions in IFRS 3, a transaction may only result in a gain from a bargain purchase to the acquirer when the **parties are not equally knowledgeable of the subject or when their measurement bases are significantly different**.

Comment Letter I - PricewaterhouseCoopers LLP (PwC, UK):

We observe that negative goodwill arises in a number of different circumstances, such as where (i) companies are sold during **periods of distress** (for example, during the recent financial crisis), (ii) **restructuring provisions** are required and contemplated in the economics of a deal but cannot be recorded at acquisition under the standard, or (iii) **share prices fluctuate** significantly subsequent to fixing the exchange ratio.

Comment Letter J - Accounting Standards Board of Japan (ASBJ, Japan):

A company found that the cause of negative goodwill was attributable to the **expectation that additional expenses** (for example, restructuring costs) **would be incurred in future periods and such expectations were already reflected in the consideration transferred**. The company stated that a mismatch in timing of recognition arose between the gains on negative goodwill and such future costs, because existing business combination standards do not permit an entity to recognize provisions for such future costs.

Comment Letter K - Confederation of Swedish Enterprise (Sweden):

We believe that in the overwhelming majority of cases where negative goodwill is created, severe **restructuring of the acquiree** is needed and restructuring provisions should give a better picture of the transaction.

Comment Letter L - Institut der Wirtschaftspruefer (IDW, Germany):

[...] negative goodwill often arises when an acquirer anticipates **future restructuring expenses** which cannot be recognized as a liability on acquisition. Expected future losses cannot always be allocated to the acquiree's assets, since by definition the fair values do not encompass the expected future losses of the entity as a whole.

Comment Letter M - Canadian Accounting Standards Board (AcSB, Canada):

Negative goodwill (and a gain) can also arise when an acquirer issues its own equity shares as consideration for an acquired business and there is a **fall in the share price** between the date the acquisition is negotiated and the date on which the acquirer obtains control of the acquiree (i.e., the acquisition date that is used in applying the acquisition method). This circumstance is particularly common in the resource industries as share prices are often significantly affected by short-term commodity price changes while reserve prices are affected by long-term commodity price changes.

Comment Letter N - BusinessEurope (Belgium):

When negative goodwill is not an indicator of restructuring or an indicator of a bargain purchase, it is usually a strong indicator that the group of assets acquired is a **single asset purchase and is not a business**.

Comment Letter O - Sanofi (France):

Negative Goodwill might be an indicator of the need for restructuring the acquiree or an indicator of a good deal. However, when we are not in one of the situations listed above, negative goodwill is a strong indicator that the group of asset acquired is a **single asset purchase and is not a business**.