

## Goodwill (Lecture A850 – 15.31 minutes)

Goodwill has been a subjective issue for many years and can prove to be a challenging area of the financial statements – especially for auditors. Over the course of 2024, we will be exploring certain elements of goodwill because the issue is quite vast to identify the challenges faced by practitioners and the issues that need to be borne in mind where goodwill is concerned.

### Identifying goodwill

FRS 102, Section 18 *Intangible Assets other than Goodwill* specifically scopes goodwill out from other intangible assets. Goodwill is dealt with in FRS 102, Section 19 *Business Combinations and Goodwill*.

Most businesses will assume there is some element of goodwill attached to it for example, the shareholders of a long-established and profitable business will assume that when it comes to selling, a purchaser will usually pay more than the underlying identifiable assets of the business may be valued at; hence an element of goodwill is inherent in the business. Goodwill has not been without controversy over the years – largely because of its subjective nature. This subjective nature was tested in the case of *Commissioners of Inland Revenue v Muller & Co Margarine* [1901] AC 217. The presiding judge, Lord MacNaghten said:

*What is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of the business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start. Goodwill is composed as a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here, and another there.*

One of the reasons that goodwill is not in the same section as other intangible assets in FRS 102 is because internally generated goodwill is not recognised on the balance sheet under any circumstances. Goodwill should only be recognised when a business combination takes place (i.e. when a parent acquires a subsidiary, or when a trade and assets purchase of a business takes place).

It is also worth noting that the Companies Act 2006 only permits goodwill to be recognised on the balance sheet to the extent that it is acquired for valuable consideration.

### Basic accounting requirements

FRS 102, para 19.22 requires an acquirer at the date of acquisition to:

- (a) recognise goodwill acquired in a business combination as an asset; and
  - (b) initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with paragraphs 19.15 to 19.15C.
- FRS 102, para 19.22

### Example – Goodwill on acquisition

On 2 January 2024, The Harper Group Ltd acquired 100% of Churchill Ltd for a consideration of £900,000. Extracts from Churchill's financial statements at the date of acquisition are as follows:

	Book value	Fair value	Tax deductions
	£'000	£'000	£'000
Property	300	400	210
Plant and machinery	200	250	75
Other current assets	100	100	100
Liabilities	(40)	(40)	(40)
	560	710	345

Churchill has unutilised corporation tax losses amounting to £35,000 and The Harper Group intends to utilise these tax losses among other group members in its portfolio through group relief. The Harper Group pays tax at 25%.

Goodwill arising on the acquisition of Churchill is as follows:

	Book value	Fair value	Tax written down value	Timing diffs	Tax rate	Deferred tax - rounded
	£'000	£'000	£'000	£'000		£'000
Property	300	400	210	190	25%	48
Plant & machinery	200	250	75	175	25%	44
Other current assets	100	100	100	-	-	-
Liabilities	(40)	(40)	(40)	-	-	-
Tax loss c/fwd	-	N/A	N/A	(35)	-	(9)
	<b>560</b>	<b>710</b>	<b>345</b>	<b>330</b>		<b>83</b>

<b>Goodwill</b>	<b>£'000</b>
Cost of investment	900
Net assets acquired	(710)
Deferred tax liability	83
<b>Goodwill</b>	<b>273</b>

### Subsequent measurement

After initial recognition, goodwill is measured at cost less accumulated amortisation and accumulated impairment losses.

### Important point

FRS 102 requires all goodwill (and intangible assets) to be amortised over their useful economic lives. There is no option under UK and Ireland GAAP to assign indefinite useful lives to goodwill (or intangible assets). This is notably different than under IFRS Accounting Standards which prohibits the amortisation of goodwill and, instead, requires goodwill to be tested for impairment every year in accordance with IAS® 36 *Impairment of Assets*.

FRS 102, para 19.23(a) requires goodwill to be amortised on a systematic basis over its useful life. This paragraph confirms that goodwill cannot have an indefinite useful life and, in exceptional cases, where management is unable to make a reliable estimate of the useful life of goodwill, the amortisation period cannot exceed ten years. It can be shorter, but it cannot be longer.

As noted above, goodwill under IFRS is not amortised; instead, it is tested annually for impairment. Under FRS 102, management would still need to assess if there are any indicators of impairment of goodwill and, if there are, to carry out an impairment test in accordance with FRS 102, Section 27 *Impairment of Assets*. Impairment of goodwill is examined in **2.4** below.

### Negative goodwill

In most cases, positive goodwill arises in the group accounts as the consideration paid in the business combination will usually be higher than the share of the net assets acquired. However, this is not necessarily the case in every business combination and there may be circumstances giving rise to a 'bargain purchase' – i.e. where the consideration paid to the outgoing shareholders is less than the fair value of the net assets acquired. This can often take place in, say, a distressed sale, where a company is in financial distress and the outgoing shareholders agree to sell the company to an acquirer at less than the fair value of the net assets.

Negative goodwill is dealt with in FRS 102, para 19.24. This paragraph takes a different approach to negative goodwill when compared to IFRS 3 *Business Combinations*. IFRS 3 requires negative goodwill to be recognised immediately in profit or loss.

However, under FRS 102, para 19.24 there are three steps to take when dealing with negative goodwill:

- (a) *Reassess the identification and **measurement** of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination.* FRS 102, para 19.24
- (b) *Recognise and separately disclose the resulting excess on the face of the **statement of financial position** on the acquisition date, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.*
- (c) *Recognise subsequently the excess up to the fair value of non-monetary assets acquired in **profit or loss** in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired shall be recognised in profit or loss in the periods expected to be benefited.*

Professional judgement will be required where (b) and (c) are concerned. For example, an acquirer may decide to allocate the negative goodwill on a pro-rata basis or to allocate it to specific assets where these can be identified. In practice, amounts which are allocated to, say, stock will be eliminated quickly; whereas amounts allocated to fixed assets may take a longer period of time to eliminate depending on depreciation policies.

### Impairment of goodwill

FRS 102, para 27.24 recognises that goodwill, on its own, cannot be sold. Goodwill does not generate cash flows for an entity which are independent of the cash flows of other assets. Hence, the fair value of goodwill cannot be measured directly. Consequently, the fair value of goodwill must be derived from measurement of the fair value of the cash-generating unit (CGU) to which it belongs.

FRS 102, para 27.26 says:

*Part of the recoverable amount of a cash-generating unit is attributable to the **non-controlling interest** in goodwill. For the purpose of impairment testing of a non-wholly-owned cash-generating unit with goodwill, the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount, by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the non-controlling interest. This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.* FRS 102, para 27.26

Therefore, where a parent does not wholly-own a subsidiary, FRS 102, para 27.26 requires the goodwill to be grossed up to include the goodwill attributable to the non-controlling interests (NCI).

This grossing up calculation must be done **before** conducting the impairment review because it is the notionally adjusted goodwill figure which is then aggregated with the other net assets of the CGU. The aggregate amount is then compared to recoverable amount to determine the value of any write-down.

### Example – Notionally adjusted goodwill

Topco Ltd owns 80% of Subco Ltd and the group has an accounting reference date of 31 August each year. On 31 August 2023, the carrying amount of Subco's net assets were £880,000, excluding goodwill of £120,000 (net of amortisation). Management have decided to restructure the group and announced this restructuring exercise immediately prior to the reporting date.

The finance director has calculated recoverable amount of Subco's net assets to be £950,000.

FRS 102, para 27.26 requires Topco to notionally adjust the goodwill to take into account the NCI. The impairment loss is calculated as follows:

	£'000	£'000
Goodwill	120	
Unrecognised NCI ( $£120k \times 20/80$ )	30	
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Notionally adjusted goodwill		150
Net assets		880
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Carrying amount		1,030
Recoverable amount		(950)
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Impairment loss		80
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All £80,000 is allocated to the notionally adjusted goodwill, but as the subsidiary is only 80% owned, only £64,000 is actually recorded as the other £16,000 is allocated to the NCI and will normally appear in their financial statements.

### Important point relating to reversals of impairment losses on goodwill

Impairment losses in respect of goodwill cannot be reversed at a subsequent date. This applies even if the circumstances giving rise to the original impairment loss cease to apply (FRS 102, para 27.28). This prohibition arose because of amendments to the Accounting Regulations in 2015 so once an impairment loss on goodwill has been recognised, it remains.