

Business combinations and goodwill (Lecture A641 – 11.51 minutes)

Group issues are largely dealt with in Section 19 *Business Combinations and Goodwill* under FRS 102; although there is a close interaction with Section 9 *Consolidated and Separate Financial Statements*. Section 9 of FRS 102 applies to all parents which are required, or voluntarily choose, to prepare consolidated financial statements.

Groups which are medium-sized and large will invariably be required to prepare consolidated financial statements unless the provisions in paragraph 9.3 (exemption from preparing consolidated financial statements) or paragraph 9.9 (exclusions from consolidation) apply.

Small groups are exempt from the requirement to prepare consolidated financial statements (section 399(2A)) of the Companies Act 2006); although that is not to say that all small groups choose to take up this exemption. Indeed, some small groups do voluntarily prepare group accounts and where this is the case, FRS 102, Section 1A *Small Entities* provides guidance for small groups in paragraphs 1A.21 and 1A.22.

This section of the course will not look in detail at the preparation of group accounts, but will look at some of the changes to the preparation of such accounts under FRS 102 and will recap on some of the key concepts involved when preparing consolidated financial statements.

The concept of control

The term 'business combination' applies when a parent company acquires a subsidiary. In this situation, the parent company obtains **control** over the subsidiary. Control is usually evidenced by way of an ownership interest of more than 50%, but this is not absolute and other characteristics of the relationship can indicate that a parent has obtained control over a subsidiary even with an ownership interest of less than 51%, such as:

- the ability to appoint or remove the majority of the board of directors (or equivalent governing body);
- the power to cast the majority of votes at meetings of the board of directors/equivalent governing body where control of the entity is by that board or body;
- the power to govern the entity's financial and operating policies under a statute or an agreement; or
- the power over more than 50% of the voting rights by virtue of an agreement with other investors.

It follows, therefore, that while control over a subsidiary is usually evidenced by an ownership interest of more than 50% of the voting rights/net assets of an entity, regard must be had to other conditions that may indicate control where the parent may not own more than 50% of the voting rights/net assets.

This is because control is based on substantive rights.

The purchase method

The purchase method of accounting is used when a parent acquires a subsidiary. FRS 102 (March 2018) contains five steps in applying the purchase method of accounting as follows:

- (a) identifying an acquirer;
- (b) determining the acquisition date;
- (c) measuring the cost of the business combination;
- (d) allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and **provisions** for **contingent liabilities** assumed and recognising and measuring any **non-controlling interest** in the acquiree; and
- (e) recognising and measuring **goodwill**.

*FRS 102 (March 2018)
para 19.7*

Is it an acquisition or is it a group reconstruction?

Group reconstructions are also dealt with in Section 19 of FRS 102 and while this course cannot go into the detailed intricacies of group reconstructions, in some situations the first question to ask is whether the transaction is an acquisition of a subsidiary OR whether it is a group reconstruction.

When a group reconstruction takes place, the use of the merger method of accounting may be used instead of the purchase method. (Note that although the standard seems to make the merger method optional, in practice it will be required in order to give a true and fair view, if the transaction is a group reconstruction). The two concepts are fundamentally different. Merger accounting uses book values of assets and liabilities to combine the merging entities (fair values are not used, but some adjustments may be necessary to achieve uniformity of accounting policies). Under the purchase method of accounting, fair values are used to consolidate the subsidiary at the date of acquisition.

In addition, to qualify for the use of the merger method of accounting, it needs not to be prohibited by company law and the ultimate equity holders need to remain the same and their rights relative to each other unchanged. Also, no non-controlling interest in the net assets of the group is altered by the transfer. This is because if the rights are changed this indicates that it is not, in fact, group reconstruction as something else is happening to change the relationship with the group and outside parties.

In many cases, however, it will be clear whether a transaction is a business combination or a group reconstruction.

Overview of the principles of consolidation

As noted above, the course will not be going into the detailed mechanics of consolidation as it is expected that practitioners will already have a sound grasp of the basics and the mechanics have not changed through the FRC's triennial review (or indeed under FRS 102).

Accounting policies

Amounts included within the consolidated financial statements should be based on coterminous accounting policies. Where a subsidiary uses accounting policies that differ to the parent in its individual financial statements, consolidation adjustments will be necessary.

Accounting period-end dates

Subsidiaries should, wherever practicable, use the same accounting reference date and accounting period as the parent. Where a different accounting reference date is used, interim financial statements should be prepared to the parent's accounting reference date for use in the consolidation. Where this is not practicable, the subsidiary's financial statements for the previous financial year should be used provided that the year-end did not end more than three months before the parent's year-end. In these situations, any changes that have taken place in the intervening period that materially affect the view given by the group accounts should be taken into account by way of adjustment in the preparation of the consolidated financial statements.

Consolidated profit and loss account

Each individual entity within the group will prepare its own financial statements (referred to as the 'individual' financial statements). The parent will then consolidate the individual financial statements with those of its own (subject to consolidation adjustments) to arrive at the consolidated financial statements.

The consolidated profit and loss account is quite straightforward. It merely consolidates, line-by-line, up to the levels of profit after tax. After profit after tax, the amounts attributable to the parent and non-controlling interest are shown.

All intra-group sales, purchases and expenses are eliminated together with any unrealised profit (for example in stock).

Intra-group dividends are eliminated from the group's investment income and intra-group interest is eliminated from investment income and interest payable as appropriate.

Consolidated balance sheet

This is more complicated to prepare than the consolidated profit and loss account. The assets and liabilities section of the consolidated balance sheet reflect the net assets that are under the control of the parent, whereas the capital and reserves section reflects the split of ownership interest between the parent and the non-controlling interest.

The table below outlines the preparation of the consolidated balance sheet:

Area	Method
Assets	Amalgamate on a line-by-line basis
Liabilities	Amalgamate on a line-by-line basis
Share capital	Parent company only
Reserves	Group reserves comprise: <ul style="list-style-type: none">• Parent's reserves <i>plus (profit) or minus (loss)</i>• Share of subsidiary's post-acquisition profit/loss
Goodwill	Capitalise and amortise
Non-controlling interest	Their share of the subsidiary's net assets at the balance sheet date

Intra-group balances (debtors and creditors) should be eliminated. In practice agreeing intra-group balances can be problematic for some groups; particularly the larger groups. If they do not immediately contra, it is more than likely due to cash or in-transit items.

Intra-group dividends should be cancelled and the consolidated financial statements should only reflect dividends payable to the non-controlling interests.

Contingent liabilities in a business combination

Contingent liabilities are treated differently in a business combination than they are in the individual financial statements of an entity under Section 21 *Provisions and Contingencies*. In the separate financial statements of a reporting entity, contingent liabilities are not recognised but are instead disclosed because they fail to meet the recognition criteria for a liability due to not meeting the full criteria for a provision in paragraph 21.4(a) to (c).

Under paragraph 19.15(c) of FRS 102, contingent liabilities whose fair value can be measured reliably are recognised. This is because the transfer of economic benefit is reflected in the contingent liability's fair value rather than it being a criterion for recognition. The fair value of a contingent liability is the amount which a third party would charge to assume the contingent liability.

If the fair value of a contingent liability cannot be reliably measured, there is a resulting impact on the amount that is recognised as goodwill or, in the case of a bargain acquisition (ie where consideration is less than net assets acquired), negative goodwill. When this situation applies, the parent must disclose information relating to that contingent liability in accordance with Section 21 of FRS 102.

Example – Contingent liability in a business combination

On 1 March 2018, Topco Ltd acquired 100% of the net assets of Subco Ltd that is in the construction industry. On the date of acquisition, Subco was actively defending a lawsuit brought against the company by one of its contractors who is alleging a breach of contract. The value of the possible payment if breach of contract is proven is £100,000 but the lawyers have said that there is only a 10% chance that the courts would uphold the claim.

The contingent liability should be recognised by Topco on acquisition at its fair value of 10% of the potential payment (£10,000) that may arise if breach of contract is proven.

Measurement after initial recognition

Paragraph 19.21 of FRS 102 says that after initial recognition, the acquirer must measure contingent liabilities at the *higher* of:

- (a) the amount which would be recognised under Section 21 *Provisions and Contingencies*; and
- (b) the amount initially recognised *less* any amounts recognised as revenue under Section 23.

Applying these subsequent measurement principles, if the provision at the next balance sheet date turns out to be higher than the amount that was initially recognised, then the provision is increased as follows:

Dr Profit and loss account	X
Cr Provisions for liabilities	(X)

On the other hand, if the provision turns out to be *lower*, the liability is not reduced; instead it continues to be measured at fair value at the date of acquisition. The exception to this rule would be where the contingency ceases to exist or, where appropriate, reduced in respect of amortisation of the liability under the revenue recognition section (Section 23). The latter would only apply if the contingent liability relates to a revenue-generating activity.

Step acquisitions

Step acquisitions (often referred to as ‘piecemeal’ acquisitions) take place when a parent acquires an additional ownership interest in a subsidiary, thus creating a reduction in non-controlling interest. Some investments can, in fact, turn into subsidiary status when additional acquisitions result in the parent owning more than 50% of the net assets of the investee because, unless there is clear evidence to suggest otherwise, the parent will have obtained control over the investee resulting in classification as a subsidiary.

Quite often a parent company, owning more than 50% of the net assets, will obtain further ownership interest in the subsidiary. It is this scenario that is significantly different than what was the case under old UK GAAP.

Under old UK GAAP, if a parent that already had control over a subsidiary, acquired a further ownership interest in the subsidiary's net assets, resulting in a diluted minority (non-controlling) interest, the net assets of the subsidiary would be revalued to fair value at the date control is increased and additional goodwill would also have been recognised. Under FRS 102 the net assets of the subsidiary are **not** revalued and **no** additional goodwill is recognised because paragraph 9.19D of FRS 102 would regard this transaction as one among equity holders in their capacity as equity holders.

Example – Acquisition of further ownership interest in a subsidiary

On 1 June 2017, Topco Ltd acquired 70% of the net assets in Subco Ltd for a purchase price of £500,000. On the date of acquisition, the fair value exercise revealed the net assets of Subco to be £380,000, which was also equivalent to book values. On 1 June 2018, Topco agreed to invest an additional £75,000 in Subco in exchange for a further 10% of the net assets and on this date Subco's net assets had a book value of £435,000 and a fair value of £485,000. The group's accounting reference date is 31 May.

Accounting for the subsidiary at the date of acquisition (1 June 2017)

At the date of acquisition, Topco has acquired control of Subco because it has acquired an ownership interest of 70% of the net assets. As a result, the identifiable assets and liabilities of Subco are consolidated at their fair value of £380,000. Positive goodwill is recognised in the consolidated financial statements of £234,000, calculated as follows:

	£
Cost of investment	500,000
Less net assets acquired:	
(70% x £380,000)	(266,000)
Positive goodwill (group accounts)	234,000

At the date of acquisition, the non-controlling interest (NCI) is £114,000 (or 30% x £380,000).

Year-end 31 May 2018

The increase in Subco's net assets amounts to £55,000 (£435,000 less £380,000) which has arisen due to the profit yielded by Subco during the year to 31 May 2018. This

profit is split £38,500 to Topco (being 70% x £55,000) and £16,500 to the NCI. The NCI share is now £130,500 (£114,000 brought forward plus £16,500).

Further acquisition on 1 June 2018

On 1 June 2017, Topco acquired a further 10% of Subco which means that the NCI share of Subco's net assets drops from 30% to 20%.

NCI's share in Subco decreases by £43,500 $((30\% - 20\%) \times £435,000)$ and their share will now equal £87,000 (£130,500 less £43,500) or 20% x £435,000.

This further acquisition is accounted for as a transaction among equity holders and the resulting change in NCI is accounted for under paragraph 22.19 of FRS 102. In this example, paragraph 22.19 would require the NCI to be adjusted to reflect the parent's additional ownership interest in the subsidiary. Any difference between the value of the NCI adjustment and the consideration paid to acquire the additional 10% interest is recognised in equity and attributed to the equity holders of the parent. Therefore, the accounting would be as follows:

	£
Dr Non-controlling interests	43,500
Dr Equity attributable to the parent	31,500
Cr Cash at bank	(75,000)

The key point to bear in mind where a parent company increases its shareholding in a subsidiary is that under FRS 102, the subsidiary's net assets are not revalued to fair value, nor is there any consequential increase to goodwill (as was the case under previous UK GAAP). FRS 102 requires the transaction to be accounted for as one among equity holders. Under FRS 102, the accounting treatment for such a transaction is inherently simpler.

Disposals

When a parent chooses to sell ownership interest in a subsidiary, there are two outcomes to the transaction: the parent either retains control of the subsidiary, or control is lost.

If control is lost, there are no differences in the accounting treatment under FRS 102 when compared to old UK GAAP. In such cases, the results of the subsidiary are included in the consolidated financial statements up to the date at which control is lost and a gain or loss (calculated as the difference between the fair value of the consideration received and the identifiable net assets (including goodwill) of the subsidiary disposed of) recognised.

In some instances, however, a parent company may dispose of some, but not all, of its ownership interest in a subsidiary and still retain control of that subsidiary following the disposal (i.e. the parent will still own more than 50% of the net assets following the disposal).

When this happens, the change in the parent's controlling interest is accounted for as a transaction among equity holders in their capacity as equity holders. In other words, the carrying amount of the non-controlling interest is increased to reflect the parent's reduced ownership interest. Any difference between the consideration received by the parent and the amount of the adjustment to non-controlling interest is recognised directly in equity.

This treatment is notably different under FRS 102 as opposed to old UK GAAP. Under old UK GAAP, a gain or loss would be recognised on the disposal and a proportion of the associated goodwill would also be written off.

Example – Partial disposal where parent retains control

On 31 March 2017, Topco Ltd disposes of a 20% ownership interest in Subco Ltd for £300,000 which reduced Topco's holding from 80% to 60%. On 31 March 2017, the carrying amount of the identifiable net assets in Subco was £500,000 and the carrying amount of goodwill on acquisition at the date of the disposal was £30,000.

Under FRS 102, no gain or loss is recognised on the disposal as the transaction is treated as one between equity holders in their capacity as equity holders because Topco still retains control of Subco.

The NCI will increase from 20% to 40% and hence the NCI's share of Subco's net assets will increase from £100,000 (£500,000 x 20%) to £200,000 (£500,000 x 40%), i.e. by £100,000. No goodwill is attributable to the NCI.

As Topco has retained control following the partial disposal, paragraph 22.19 of FRS 102 will apply. The carrying amount of the NCI will be adjusted to reflect the change in Topco's ownership of Subco's net assets. The difference between the NCI adjustment and the fair value of the consideration received is recognised directly in equity and attributed to the equity holders of Top. The journals are:

	£
Dr Cash at bank	300,000
Cr Non-controlling interest	(100,000)
Cr Equity attributable to Topco	(200,000)

Illustrative statement of changes in equity showing change in ownership interest

Group	Called-up share capital £'000	Retained earnings £'000	shareholders' equity £'000	Total controlling interest £'000	Non Total equity £'000
At 01.04.2016	10	240	250	60	310
Profit for the year		120	120	30	150
Equity dividend		(50)	(50)		(50)
At 31.03.2017	10	310	320	90	410

Profit for the year	40	40	10	50	
Equity dividend	(10)	(10)		(10)	
Change in ownership	200	200	100	300	
At 31.03.2018	10	540	550	200	750