

## Business combinations and goodwill (Lecture A766 – 15.12 minutes)

Group issues are largely dealt with in FRS 102, Section 19 *Business Combinations and Goodwill*; 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 FRS 102, para 9.3 (exemption from preparing consolidated financial statements) or para 9.9 (exclusions from consolidation) apply. There are also exemptions in company law that may be claimed in certain circumstances.

It should be noted that groups are beyond the scope of FRS 105.

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.

### 1.1 The concept of control

The term 'business combination' is defined as:

*The bringing together of separate entities or **businesses** into one reporting entity.*

A business combination usually takes place when one entity (the parent) obtains control over another entity (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 50.01%, 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.

FRS 102  
Glossary  
**business  
combination**

An investor which only holds **protective rights** does not have the power to direct the activities of the entity. The term 'protective rights' refers to those rights which are designed to protect the interests of the party holding those rights without giving that party power over the entity to which those rights relate.

The substantive rights which create control must be exercisable when the decision concerning the direction of the relevant activities needs to be made. Control will ordinarily be obtained in two specific situations:

- (a) The parent company will own more than half (i.e. more than 50%) of the voting rights in the subsidiary.
- (b) The parent company has the ability to direct the financial and operating policies of the entity.

#### Example – Control obtained through direct ownership

Topco Ltd owns 85% of the voting rights in Subco Ltd.

As Topco owns more than half of the voting rights in Subco, it is presumed that Topco has obtained control, hence a parent-subsidiary relationship is created. In this context, Topco will be required to prepare group accounts assuming no exceptions or exemptions are available.

#### Example – Control obtained via other means

Topco Ltd acquires a 40% ownership interest in Subco Ltd. The terms of the agreement state that Topco has the ability to appoint, or remove, the majority of the board of directors.

In this example, Topco has not obtained control via its ownership interest of 40%. However, because Topco has the ability to appoint, or remove, the majority of the board of directors, this gives rise to control and hence a parent-subsidiary relationship is created and group accounts will need to be prepared if there are no exceptions/exemptions which can be claimed.

## 1.2 The purchase method

The purchase method of accounting is used when a parent acquires a subsidiary. FRS 102, para 19.7 outlines the way in which the purchase method of accounting works as follows:

- (a) Identify an acquirer
- (b) Determine the acquisition date

- (c) Measure the cost of the business combination
- (d) Allocate the cost of the business combination at the date of acquisition to the assets acquired and liabilities and provisions for contingent liabilities assumed and recognise and measure any non-controlling in the acquiree
- (e) Recognise and measure goodwill

The purchase method of accounting must start from the date of acquisition, which is the date on which the acquirer gains control of the acquiree. It must be kept in mind that it is not necessary for a transaction to be completed in law before the acquirer obtains control. Instead, FRS 102, para 19.10A requires all pertinent facts and circumstances surrounding a business combination to be taken into account when assessing if the acquirer has obtained control.

#### **Is it an acquisition or is it a group reconstruction?**

Group reconstructions are also dealt with in FRS 102, Section 19 and while this course cannot go into the detailed intricacies of group reconstructions due to time constraints, 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.

### **1.3 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, but an overview is as follows.

#### **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 must 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 of the group.

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.

Eliminating intra-group transactions and balances is essential if the consolidated financial statements are to present a true and fair view. The overarching objective of the group accounts is to present the results of the group in line with its economic substance, which is that of a **single** reporting entity (i.e. as if the group structure did not exist).

### 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"> <li>• Parent's reserves <i>plus (profit) or minus (loss)</i></li> <li>• Share of subsidiary's post-acquisition profit/loss</li> </ul>
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) must 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 must be cancelled and the consolidated financial statements should only reflect dividends payable to the non-controlling interests.

#### **1.4 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 FRS 102, 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 FRS 102, para 19.15(c), 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. In practice, when an acquiree has a contingent liability, the acquirer will seek to pay less for the business given the fact that there is a risk the contingent liability will crystallise, hence the acquirer will suffer an outflow of funds further down the line. The result of this is a reduction in net assets acquired and a corresponding increase in positive goodwill, or a reduction in negative goodwill.

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 (i.e. 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 2021, Topco Ltd acquired 100% of the net assets of Subco Ltd. On the date of acquisition, Subco was actively defending a lawsuit brought against the company by one its contractors who is alleging a breach of contract. The maximum amount of the possible payment if breach of contract is proven is judged to be £100,000. The lawyers have said there is a 60% chance Subco will pay nothing, a 15% chance they will pay £90,000 and a 25% chance they will have to pay £100,000.

A contingent liability of £38,500  $[(60\% \times \text{£nil}) + (15\% \times \text{£90,000}) + (25\% \times \text{£100,000})]$  is discounted to present value and is recognised in respect of the claim. This provision must take into account the range of probable outcomes. This would be the case even if no payment is required.

### Measurement after initial recognition

FRS 102, para 19.21 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.

### Example – Potential reduction in a contingent liability

Using the example above in respect of the breach of contract. If it is assumed that at the next balance sheet date the case is still ongoing, but the lawyers advise the subsidiary that there is now a 60% chance of paying nothing, a 15% chance of paying £80,000 and a 25% chance of paying £70,000 (i.e. the contingent liability is now £29,500 rather than £38,500), the contingent liability is not reduced. It continues to be recognised at its fair value at the date of acquisition.

However, if the lawyers now state that there is a 60% chance Subco will pay £10,000, a 15% chance it will pay £95,000 and a 25% chance it will pay £100,000, the provision is increased by £6,750, i.e:

	£
60% x £10,000	6,000
15% x £95,000	14,250
25% x £100,000	25,000
	<hr/>
	45,250
Less original provision	(38,500)
Increase in provision	6,750
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• Dr Profit and loss	£6,750
• Cr Provisions for liabilities	£6,750

## 1.5 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. When this happens, under FRS 102 the net assets of the subsidiary are **not** revalued and **no** additional goodwill is recognised because FRS 102, para 9.19D 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 2020, 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 2021, 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 2020)

At the date of acquisition, Topco has acquired control of Subco because it is acquired an ownership interest of 70% of the net assets. Consequently, 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)	<u>(266,000)</u>
Positive goodwill (group accounts)	<u>234,000</u>

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

### Year end 31 May 2021

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 2021. 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 2021

On 1 June 2021, 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%) x £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 FRS 102, para 22.19. 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. FRS 102 requires the transaction to be accounted for as one among equity holders in their capacity as equity holders.

## 1.6 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 (i.e. the parent's ownership interest falls to be less than half following the disposal), the results of the subsidiary are included in the consolidated financial statements up to the date on 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) is 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.

### Example – Partial disposal where parent retains control

On 31 March 2021, 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 2021, 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, FRS 102, para 22.19 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 Topco. The journals to record this transaction 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	Retained earnings	Total shareholders' equity	Non- controlling interest	Total equity
	£'000	£'000	£'000	£'000	£'000
At 01.04.2019	100	240	250	60	310
Profit for the year		120	120	30	150
Equity dividend		(50)	(50)		(50)
At 31.03.2020	100	310	320	90	410
Profit for the year		40	40	10	50
Equity dividend		(10)	(10)		(10)
<b>Change in ownership</b>		<b>200</b>	<b>200</b>	<b>100</b>	<b>300</b>
At 31.03.2021	100	540	550	200	750

#### Deemed disposals

An undertaking may cease to be a subsidiary of a parent, or the group may reduce its ownership interest, as a result of a deemed disposal. A deemed disposal may arise when:

- (a) the group does not take up its full allocation of rights in a rights issue;
- (b) the group does not take up its full share of a scrip dividend;
- (c) another party exercises its options or warrants; or
- (d) the subsidiary issues shares to other non-group parties (non-controlling interests).

Deemed disposals have the same effect as changes in ownership by disposal and should be accounted for in the same way.

Again, if the parent still retains control of a subsidiary following the deemed disposal, the transaction is accounted for as a transaction between shareholders. No gain or loss is recorded in the group accounts.

### Example – Deemed disposal

Topco Ltd owns 600,000 of the 1 million shares in Subco Ltd which resulted in Topco obtaining a 60% ownership interest. A year later, Subco issues a further 90,909 shares to a third party for £17m. Immediately prior to the share issue, Subco's net assets are £100m.

Following the issue of the shares, Topco's interest in Subco becomes diluted from 60% to 55% (600,000 / 1,090,909). Topco still retains control of Subco because its ownership interest is more than 50%.

This deemed disposal is accounted for as a transaction among the shareholders. Topco does not recognise any gain or loss on disposal and does not adjust any goodwill which was previously recognised. All Topco does in the consolidated financial statements is:

	£
Dr Cash at bank	17m
Cr Non-controlling interest	12.65m*
Cr Equity	4.35m

\*Previously, the NCI were 40% and the net assets of Subco are £100m, hence 40% x £100m = £40m. NCI is now 45% and therefore 45% x £117m (£100m net assets plus £17m proceeds from share issue) = £52.65m. Hence £52.65m less £40m is an increase of £12.65m.

## 1.7 Goodwill

The accounting issues for goodwill are combined with those of business combinations under FRS 102 as opposed to being included in Section 18 *Intangible Assets other than Goodwill*. This is because internally generated goodwill is never recognised on the balance sheet and to reinforce this principle, accounting issues surrounding goodwill were included in Section 19 as goodwill will usually only arise when a business combination takes place.

It should also be borne in mind that the Companies Act 2006 only permits goodwill to be recognised on a balance sheet to the extent that it has been acquired for valuable consideration.

### **Initial recognition and subsequent measurement**

Positive goodwill is essentially the excess of the consideration over the net assets acquired.

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

FRS 102 requires goodwill to be amortised on a systematic basis over its useful life. There is no option under the standard to assign an indefinite life to goodwill. This is notably different than the IFRS regime which does not allow goodwill to be amortised; instead it is tested annually for impairment.

In rare cases when management are unable to assign a reliable useful economic life to goodwill, FRS 102, para 19.23(a) caps the amortisation period to ten years. The amortisation period can be shorter, but it cannot be longer. This cap should only be used in exceptional cases because in most instances it is likely that a reliable useful life can be assigned to goodwill.

### **Negative goodwill**

Positive goodwill will usually arise in a business combination which is when the parent pays more than fair value for its share of the net assets in the subsidiary. However, there may be situations giving rise to a 'bargain purchase' which is where the consideration paid for the parent's share of the subsidiary's net assets is less than fair value. This is likely to arise in a distressed sale or when the shareholders want a quick exit out of the business and hence are willing to accept a lower than fair value price.

Negative goodwill is dealt with in FRS 102, para 19.24. This paragraph takes a different approach to dealing with negative goodwill than the IFRS regime (which requires negative goodwill to be immediately recognised in profit or loss). According to FRS 102, para 19.24 there are three steps to dealing 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.
- (b) Recognise and separately disclose the resulting excess on the face of the balance sheet at the date of acquisition, immediately below goodwill, 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 is recognised in profit or loss in the periods that are expected to be benefited.

Of course, professional judgement will be required where (b) and (c) are concerned. For example, an acquirer may decide to allocate the excess on a pro-rata basis or to allocate the excess 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 the entity's depreciation policies.